85-519

No. ———

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

October Term, 1985

DR. WILLIAM C. RANDALL, DR. ROGER E. AUSTIN, DR. TOM W. ANDERSON and DR. MYREL A. NEUMANN,

Petitioners,

v.

B. J. LOFTSGAARDEN; ALOTEL INCORPORATED, a Minnesota corporation; PROPERTY DEVELOPMENT AND RESEARCH COMPANY, a Minnesota corporation; and 2361 BUILDING CORPORATION, a Minnesota corporation,

Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

Robert Arthur Brunig
O'CONNOR & HANNAN
3800 IDS Tower
80 South Eighth Street
Minneapolis, Minnesota 55402
Telephone: (612) 343-1200
Attorney for Petitioners
Of Counsel:
Terence M. Fruth
FRUTH & ANTHONY, P.A.
1300 International Centre
900 Second Avenue South
Minneapolis, Minnesota 55402
Telephone: (612) 349-6969

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QUESTIONS PRESENTED

1. Whether favorable tax consequences to defrauded investors in a limited partnership, together with imputed interest thereon, constitute "income received" which section 12(2) of the Securities Act of 1933 requires be deducted from the consideration paid when the investors' purchase of the securities is rescinded.

2. Whether favorable tax consequences to defrauded investors in a limited partnership, together with imputed interest thereon, are to offset rescissionary damages awarded pursuant to section 10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission Rule 10b-5 to insure that the investors do not recover more than "actual damages."*

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*A similar issue is raised both by a petition for certiorari in *Salcer v. Envicon Equities Corp.*, No. 84-1447 (U.S., filed Mar. 13, 1985) and by a petition for certiorari in *Freschi v. Grand Coal Venture*, No. 85-377 (U.S., filed Sept. 6, 1985).

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B. J. LOFTSGAARDEN; ALOTEL INCORPORATED, a Minnesota corporation; PROPERTY DEVELOPMENT AND RESEARCH COMPANY, a Minnesota corporation; and 2361 BUILDING CORPORATION, a Minnesota corporation,

Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

Petitioners respectfully pray that a writ of certiorari issue to review the *en banc* judgment and opinion of the United States Court of Appeals for the Eighth Circuit entered in this proceeding on July 16, 1985.

OPINIONS BELOW

The *en banc* opinion of the Eighth Circuit and the accompanying panel opinion (hereinafter *"Austin II"*) are reported at 768 F.2d 949 and are set forth in Appendix A. The unreported Amended Judgment and Order of the district court on an earlier remand are set forth in Appendices

B and C. The earlier opinion of a panel of the Eighth Circuit (hereinafter "*Austin I*") is reported at 675 F.2d 168 and is set forth in Appendix D. The unreported Findings of Fact, Conclusions of Law and Order for Judgment and Memorandum Order of the district court are set forth in Appendices E and F.

JURISDICTIONAL STATEMENT

The judgment of the Court of Appeals for the Eighth Circuit was entered on July 16, 1985. This petition for certiorari is being filed within ninety days of that date. This Court's jurisdiction is invoked pursuant to 28 U.S.C. § 1254(1).

STATUTES AND REGULATION

The case involves section 12(2) of the Securities Act of 1933, 15 U.S.C. §77*l*(2); section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b); section 28(a) of the Securities Exchange Act of 1934, 15 U.S.C. §78bb(a); and Rule 10b-5 of the Securities Exchange Commission, 17 C.F.R. §240.10b-5. Because of the length of the statutes and regulation, their text is set forth in Appendix G.

STATEMENT OF THE CASE

Petitioners are four investors who purchased one or more units[1] in Alotel Associates, a limited partnership formed to operate a Ramada Inn in Rochester, Minnesota. Respondents are the individual and corporate general partners of Alotel Associates and their affiliates.

Respondents distributed an Offering Memorandum to potential investors, including Petitioners. The Offering

[1]The price of each unit was $35,000.00.

Memorandum purported to describe the limited partnership, the Ramada Inn project, the terms available for financing the partnership's activities and the timetable for constructing the Ramada Inn. The Offering Memorandum contained a *pro forma* projection of cash flow, of resale price and profit at the time of sale and of the tax consequences of a limited partner's investment.

The Offering Memorandum misrepresented the rate and amount of interest to be paid for construction financing, the length of a ground lease, the completion date and the terms of financing available for furnishings and equipment. The Offering Memorandum described a non-existent commitment for long-term financing. The Offering Memorandum omitted information about the control B. J. Loftsgaarden ("Loftsgaarden") exercised over Alotel Incorporated, Property Development and Research Company ("PDRC") and 2361 Building Corporation, about PDRC's anticipated profits on a sale of land, about a commitment fee to be paid to PDRC and about Loftsgaarden's ownership of arc-TECH, inc., a firm which was to design the building and to supervise construction.

The limited partners' investments and the available loans proved insufficient to construct and furnish the Ramada Inn. Alotel Associates had no initial operating capital. Alotel Associates was forced to obtain additional investors. The additional investments proved insufficient, and the business continued to flounder. The investors made several loans to Alotel Associates.[2] Alotel Associates ultimately defaulted on its loans and its rental payments, and its creditors foreclosed.

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[2]The total loans "assessed" against each unit was $8,500.00.

Petitioners brought suit under section 12(2) of the Securities Act of 1933 [hereinafter "section 12(2)"], section 10(b) of the Securities Exchange Act of 1934 [hereinafter "section 10(b)"], under Securities and Exchange Commission Rule 10b-5 (hereinafter "Rule 10b-5"), under the antifraud provisions of the Minnesota Uniform Securities Act and under the common law of Minnesota. Petitioners alleged fraud and omission of material information and sought rescission or damages.

Respondents denied liability. They also argued that reductions in Petitioners' federal and state income tax liabilities which flowed from Petitioners' investments in Alotel Associates constituted "income received," which section 12(2) mandates be deducted from any recovery which the district court awarded to Petitioners if it granted rescission. Respondent also argued that the tax consequences reduced the "actual damages" to which Petitioners might be entitled under section 10(b) and Rule 10b-5.

The district court sustained objections to evidence which Respondents sought to introduce concerning the tax consequences of Petitioners' investments in Alotel Associates. The district court determined that the "out-of-pocket [and] rescissionary measures [of damages] would yield the same results." Appendix at F-7. Based upon the jury's verdict and its own findings, the district court awarded Petitioners judgment in amounts equal to the amounts of their investments plus interest[3] on the amounts of their investments.[4]

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[3]Interest was awarded pursuant to the statutory mandates in section 12(2) and in Minn. Stat. §80A.23, subd. 2. Another basis would have been the provision of Minnesota law which allows an award of prejudgment interest if a judgment is for a "sum certain" or does not depend on any contingency and can be ascertained by reference to a generally recognized standard. *See, e.g., Oliver-Elec. Mfg. Co. v. I.O. Teigen Constr. Co.*, 183 F. Supp. 768, 769 (D. Minn. 1960).

[4]The district court denied Petitioners a return of their "loans" to Alotel Associates. *Austin II* at 951 n.2.

Respondents appealed. The Eighth Circuit affirmed the jury's and the district court's findings of liability, but the Eighth Circuit vacated and remanded to the district court for a new trial on the issue of damages. The Eighth Circuit held that

> in a private securities fraud action involving an investment structured and marketed as a tax shelter, where a rescissory measure of damages is applied, evidence of any benefit derived by the plaintiff/investor via tax savings must be permitted.

Austin I at 183-84. The Eighth Circuit also held that "the damage award must be reduced by any value shown to have been received by plaintiffs." *Austin I* at 181.

On remand, the district court stated:

> [T]he starting point for assessing damages will be the amount each plaintiff paid Loftsgaarden for his investment (in other words, the plaintiff's consideration). To this, the court will add 8 percent interest from the date the consideration was paid to the date of this order. Finally, the amount of each plaintiff's tax benefits will be subtracted from the sum of his consideration and interest.

Appendix at C-5. The district court then made the following calculations and awards:

Plaintiff Anderson	
Consideration paid June 2, 1983:	$35,000.00
Plus interest at 8% to February 22, 1984:	$64,787.00
Minus tax benefits:	$29,615.00
Total Damages:	$35,172.00

Plaintiff Austin	
Consideration paid June 6, 1983:	$35,000.00
Plus interest at 8% to February 22, 1984:	$64,610.00
Minus tax benefits:	$33,333.00
Total Damages:	$31,277.00
Plaintiff Ne[u]mann	
Consideration paid August 21, 1973:	$35,000.00
Plus consideration paid October 19, 1973:	$17,500.00
Plus interest at 8% to February 22, 1984:	$96,385.00
Minus tax benefits:	$57,014.00
Total Damages:	$39,371.00
Plaintiff Randall	
Consideration paid November 13, 1973:	$35,000.00
Plus interest at 8% to February 22, 1984:	$63,770.00
Plus consideration paid 1975:	$ 2,512.00
Plus interest at 8% to February 22, 1984:	$ 4,203.00
Subtotal:	$67,973.00
Minus tax benefits:	$36,404.00
Total Damages:	$31,569.00

Appendix at B-1-2.

Respondents again appealed. The Eighth Circuit *sua sponte* granted *en banc* consideration as to whether *Austin I* should be reconsidered and as to whether damages had been calculated properly if *Austin I* had been decided properly. *Austin II* at 951. The Eighth Circuit holds that *Austin I* had been correctly decided and that *Austin I* requires a further reduction in the recovery when ever a court order rescission under section 12(2); it adopts a

formula for computing damages: two times the sum of the amount paid for the security with interest, less the amount of tax benefits received with imputed interest. The Eighth Circuit therefore reduced the awards to the following: Austin ($7,666), Anderson ($18,790), Neumann ($1,984), Randall ($506). *Austin II* at 961.

Petitioners now pray that a writ of certiorari issue to review the Eighth Circuit's decision.

REASONS FOR ISSUING THE WRIT

I.

THE EIGHTH CIRCUIT'S DECISION CONFLICTS WITH THE DECISIONS OF OTHER COURTS OF APPEAL

A.

The Eighth Circuit's Decision Conflicts With A Decision Of The Ninth Circuit As To The Proper Interpretation Of Section 12(2).

Section 12(2) provides that a defrauded purchaser of a security who tenders the security to the seller is entitled

> to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon . . . .

The Eighth Circuit recognizes that "tax benefits received are [not] income in a strict accounting sense."[5] *Austin II* at 955. Nevertheless, the Eighth Circuit holds that

> section 12(2)'s requirement that "income received" be

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[5]John M. Carlson, an accounting expert called by Respondents, provided the only testimony concerning whether "tax benefits" constituted "income;" he readily conceded that "tax benefits" were not "income."

> deducted [requires] that all economic benefits bargained for and received must be deducted.

Id.

In so holding, the Eighth Circuit concedes that its interpretation might conflict with the one adopted by the Ninth Circuit in *Western Fed. Corp. v. Erickson*, 739 F.2d 1439, 1444 (9th Cir. 1984) and reaffirmed in *Burgess v. Premier Corp.*, 727 F.2d 826, 837-38 (9th Cir. 1984). The Eighth Circuit seeks to justify a distinction by characterizing Petitioners' recovery under section 12(2) as "rescissionary damages," *Austin II* at 953, and by stating that "a different situation might exist in a case involving actual rescission." *Id.* at 955 n.11; *see also id.* at 952 n.4.

The Eighth Circuit's characterization flies in the face of the district court's findings and in the face of *Austin I*'s rejection of an argument that "rescission under [section] 12(2) was not an available remedy." *Austin I* at 179. The characterization also disregards the statutory language which permits recovery of damages under section 12(2) only if a defrauded purchaser "no longer owns the security." 15 U.S.C. § 77*l*(2); *see also Johns Hopkins Univ. v. Hutton*, 297 F. Supp. 1165, 1226 (D. Md. 1968), *rev'd on other grounds*, 422 F.2d 1124 (4th Cir. 1970), *cert. denied*, 416 U.S. 916 (1974).

The Eighth Circuit's best rationale is that its interpretation reflects "economic reality" and that to ignore "tax benefits actually realized . . . would be unrealistic." *Id.* at 955 & n.9. That rationale flies in the face of the cardinal principle underlying rescission: "[r]escission voids the transaction and returns to [each] part[y] the consideration [he] paid." *Burgess v. Premier Corp.*, 727 F2d at 837. The Eighth Circuit gives lip service to the principle by stating that "[t]he goal of rescission under section 12(2) is to return the parties

to the status quo ante," *Austin II* at 954, and purports to return Petitioners to the status quo ante. The Eighth Circuit, however, never purports to return Respondents to the status quo unlawfully obtained profits. By permitting Respondents to retain a profit of at least $100,000, *id.* at 963 (dissenting opinion), the Eighth Circuit's interpretation fails to apply another basic principle of rescission: in shaping a remedy, a court should give the defrauded person, rather than the defrauder, any windfall. *Janigan v. Taylor,* 344 F.2d 781, 186 (1st Cir.), *cert denied,* 382 U.S. 879 (1965); *see also Gerstle v. Gamble-Skogmo, Inc.,* 478 F.2d 1281, 1305 (2d Cir. 1973); *Johns Hopkins Univ. v. Hutton,* 297 F. Supp. at 1226.

The Ninth Circuit takes an opposite view. When a district court ruled:

> While this Court has *considered* the economic benefits to the plaintiffs from their investments with the defendants, as required by *Austin* [*I*], it concludes that the defendants should not be given any credit,

Western Fed. Corp. v. Davis, 553 F. Supp. 818, 820 (D. Ariz. 1982) (emphasis in original), the Ninth Circuit affirmed:

> Appellants argue that the district court erred by refusing to reduce the judgment by the amount of tax benefits appellees realized from their investment in the Project. Our recent decision in *Burgess v. Premier Corp.,* 727 F.2d 826, 837-38 (9th Cir. 1984) refused to deduct tax benefits in a securities case and specifically endorsed the reasoning of the district court in this case. The appellants' argument is without merit.

Western Fed. Corp. v. Erickson, 739 F.2d at 1444; *accord, Johns Hopkins Univ. v. Hutton*, 297 F. Supp. at 1232 (cash payments to be applied to taxes were "not to be classified as . . . 'income' ").

The Ninth Circuit does not permit deduction of tax benefits from a defrauded investor's recovery under section 12(2). The Eighth Circuit limits such a recovery to the purchaser's consideration paid plus interest thereon less the amount by which his state and federal income taxes are reduced as a result of his investment plus interest on the tax reduction. Thus, the conflict is complete.

B.

The Eighth Circuit's Decision Conflicts Both With Decisions Of The Ninth Circuit And With Decisions Of The Second Circuit As To The Measure Of Damages Under Rule 10b-5.

Neither section 10(b) nor Rule 10b-5 creates an express private right of action. *E.g., Herman & MacLean v. Huddleston*, 459 U.S. 375, 379-80 (1983); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 196 (1976); *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971). Nevertheless, courts have recognized such a private right for almost forty years. *Herman & MacLean v. Huddleston*, 459 U.S. at 380 n.10; *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 513-14 (E.D. Pa. 1946). The "legal" remedy for that right is "actual damages." 15 U.S.C. § 78bb(a).

The Eighth Circuit purports to apply the "actual damages" limitation. In doing so, the Eighth Circuit concludes that, in order to limit a defrauded purchaser's recovery to his "actual damages," a court must reduce damages by "the tax benefits [the purchaser] received." *Austin II* at 955. In so holding, the Eighth Circuit states:

> [A]ll economic benefits bargained for and received must be deducted from plaintiffs' damages because "the strictly compensatory nature of damages awarded in private securities fraud actions requires that such value be taken into account in determining whether and to what extent damages were inflicted upon plaintiffs."

Id., quoting Austin I at 183. The Eighth Circuit goes on:

> [I]n order for the plaintiffs to be truly made whole, and to be returned to the status quo ante, both the tax benefits received *and* the tax consequences of their recovery must be taken into account.

Id. at 960 (emphasis in original).

The Ninth Circuit rejects both the Eighth Circuit's reasoning and its result:

> [The defendants] claim that the tax benefits received by the [plaintiffs] should be deducted from the damage award. In this case, deduction of the tax benefits from damages is inappropriate. The purpose of the damages is to place the [plaintiffs] in as good a position financially as that in which they would have been had they not made the transaction. . . . At first appearance it seems inequitable to award the [plaintiffs] their pretax out of pocket losses . . . . [T]o simply subtract the tax benefits from damages would place an unfair burden on taxpayers generally. . . . Such a result leaves the government bearing the cost of defendants' fraud. A better result is to set damages equal to the [plaintiffs'] losses exclusive of tax benefit. The [plaintiffs] will not receive a double benefit from this measure of damages because under the tax benefit rule their prior tax benefits will be disallowed. . . .
>
> We are aware that in other circumstances tax consequences have been considered in determining damages. . . .

> In such cases where there is prospective calculation of damages for which no past tax benefits have been claimed, it is appropriate to calculate damages net of taxes. . . . [Such a] situation is clearly different from the present tax shelter situation in which the [plaintiffs] have received substantial benefits at government expense.

Burgess v. Premier Corp., 727 F.2d at 837-38. The Ninth Circuit goes on to consider the holding in *Austin I* and declines to follow it. *Id.* at 838. The Ninth Circuit concludes:

> While we agree that consideration of tax consequences is relevant for certain purposes, we decline to make the government the banker for fraudulent tax shelter activity. Judge Hardy's analysis in *Western Federal Corp. v. Davis*, 553 F. Supp. 818, 820 (D. Ariz. 1982) is correct in discerning that the economic benefit by way of tax deductions is illusory because amended returns will have to be filed under the tax benefit rule. Mertens *Law of Federal Income Tax*, §7.37.

Id.; accord, Western Fed. Corp. v. Erickson, 739 F.2d at 1444; *Johns Hopkins Univ. v. Hutton*, 297 F. Supp. at 1232 ("amounts to be applied to taxes were payments for that purpose, and are therefore not to be considered as either 'income' or 'consideration' "); *cf. Eisenberg v. Gagnon*, 766 F.2d 770, 782 (3d Cir. 1985).

The Second Circuit takes yet another approach. The Second Circuit states:

> To the extent that plaintiffs invested in a tax shelter, all benefits they received from their investment, including tax benefits, would have to be deducted in calculating the rescissionary damages, if any to which they would be entitled.

Salcer v. Envicon Equities Corp., 744 F.2d 935, 940-41 (2d Cir. 1984), *petition for cert. filed*, 53 U.S.L.W. 3688 (U.S. Mar. 13, 1985) (No. 84-1447); *accord, Freschi v. Grand Coal Venture*, 767 F.2d 1041, 1050-51 (2d Cir. 1985), *petition for cert. filed*, 54 U.S.L.W. 3154 (U.S. Sept. 6, 1985) (No. 85-377).[6] Although that part of the Second Circuit's decision is consistent with the Eighth Circuit's decision, *see Austin II* at 955, the Second Circuit goes on to deny a plaintiff recovery of the interest and penalties assessed against him and makes no allowance for the tax consequences of the recovery. *Freschi v. Grand Coal Venture*, 767 F.2d at 1050-51.

The Ninth Circuit refuses to permit tax consequences of an investment to increase or decrease damages available under section 10(b) and Rule 10b-5. The Second Circuit requires a reduction of damages based upon tax deductions taken prior to recovery, but it does not permit an increase of damages to compensate for taxes which are to be imposed on the recovery, and it awards no interest because interest would constitute "a windfall resulting from [the] opportunity to use money." *Freschi v. Grand Coal Venture*, 767 F.2d at 1051.[7] The Eighth Circuit requires a reduction for tax deductions prior to recovery and an addition for taxes to be imposed on the recovery itself and insists interest be added to (and subtracted from) the annual balances.

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[6] *Salcer v. Envicon Equities Corp.* and *Freschi v. Grand Coal Venture* are Rule 10b-5 cases based on rescissionary damage theories, not section 12(2) rescission cases.

[7] One commentator noted:

> If [income tax benefits have been obtained by the investor and if those benefits reduce rescission damages], the investor is in effect paying to the general partner or promoter the tax benefits which [the investor] obtained—thereby providing a windfall to the defendants . . . .

S. Banoff, *To What Extent Will Benefits from Tax Shelters be Permitted to Offset Rescission Damages*, 57 J. TAXATION 154, 157 (1982).

Thus, there is a conflict which runs three ways. It is up to this Court to resolve that conflict. Note, *Tax Shelter Schemes & Damages in the Eighth Circuit,* 18 CREIGHTON L. REV. 1307, 1328 (1985).

II.

THE EIGHTH CIRCUIT'S DECISION MISINTERPRETS THE APPLICABLE STATUTES.

In *Ernst & Ernst v. Hochfelder,* 425 U.S. at 197, this Court stated that "the starting point" for the interpretation of the federal securities laws "is the language [of the statute] itself." The Eighth Circuit disregards the clear language of section 12(2) and effectively rewrites the statute under the guise of interpreting it. The Eighth Circuit also misconstrues section 28(a) of the Securities Exchange Act of 1934 [hereinafter "section 28(a)"].

Absent a clearly expressed legislative intent to the contrary, the language of a statute must ordinarily be regarded as conclusive. *Consumer Prod. Safety Comm'n v. GTE Sylvania, Inc.,* 447 U.S. 102, 108 (1980). In construing a statute, the statute's meaning must be sought first from the language employed. If the language itself is plain, it is the duty of a court to enforce the statute as written. *United States v. Standard Brewery, Inc.,* 251 U.S. 210, 217 (1920). If the wording of a statute is plain, simple and straightforward, the words employed must be accorded their normal meaning. *Kananen v. Matthews,* 555 F.2d 667, 670 (8th Cir.), *cert. denied sub. nom. Kananen v. Califano,* 434 U.S. 939 (1977); *see also Helvering v. Hammel,* 311 U.S. 504, 510-11 (1941).

A.

The Eighth Circuit's Decision Distorts The Normal Meaning Of Section 12(2).

Section 12(2)'s language is straightforward. The statute allows a defrauded purchaser

> to recover the consideration paid for such security with interest thereon, less the amount of any security received thereon, upon tender of such security . . . .

The formula has three parts: (1) the consideration paid, (2) interest on the consideration and (3) income received.

The district court consistently attempted to be faithful to the canons of statutory construction. At the end of the first trial, the district court refused to reduce the recovery under section 12(2) on account of tax benefits. Appendix at F-7-10. After the Eighth Circuit directed that "tax benefits" be equated with "income," the district court on remand stated:

> [The defendants'] approach would be to subtract the tax benefits from consideration paid before adding on interest, a course that drastically reduces or completely obliterates each plaintiff's award. However, the clear language of [section] 12(2) presents the order in which to consider these items: "consideration paid . . . with interest thereon, less the amount of any income received . . . ." These words present an express directive to this court, and [the] defendant[s] cite no cases directly on point which hold to the contrary.

Appendix at C-7.

Although the Eighth Circuit acknowledges that "tax benefits received are [not] a form of income in a strict accounting sense," *Austin II* at 955, it nevertheless holds that

> section 12(2)'s language "income *received* thereon" may properly be construed as including tax benefits bargained for and received . . . .

Id. at 958 (emphasis in original).

The Eighth Circuit disregards the "normal meaning" of the word "income." "Income" means "gain derived from capital, from labor, or from both combined." *Eisner v. Macomber*, 252 U.S. 189, 207 (1920).[8] "Income" does not include every favorable economic consequence,[9] *see United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 855 (1975) ("payment of interest, with its consequent deductibility for tax purposes," does not constitiute income within context of federal securities laws), and "loss" does not include every unfavorable one. If "income" and "loss" were to be construed to do so, damage calculations (and tax returns) would be required to account for all unrecognized appreciation, depreciation, changes in market price and opportunity costs. *E.g., Wolf v. Banco Nacional de Mexico, S.A.*, 739 F.2d 1458 (9th Cir. 1984), *cert. denied*, 83 L.Ed.2d 778 (1985) (claim of damage based on change in value of Mexican peso in comparison to American dollar).

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[8]One commentator noted that "*Austin* is without precedent in classifying tax benefits received by the plaintiff as 'income' within the meaning of section 12(2)." Note, *Austin v. Loftsgaarden: Securities Fraud in Real Estate Limited Partnership Investments*, 16 CREIGHTON L. REV. 1140, 1151 (1982).

[9]Respondents themselves did not argue that tax benefits constituted income. *Austin II* at 958 ("Loftsgaarden argues that . . . tax benefits are a return of 'consideration paid' "). In addition, their expert witness testified that "tax benefits" were not "income."

The Eighth Circuit also disregards the normal meaning of another portion of section 12(2). The Eighth Circuit concedes that under section 12(2) a defrauded purchaser will only be entitled "to recover the amount paid for [the security] with interest, less the amount received with interest." *Austin II* at 959, *quoting Murphy v. Cady*, 30 F. Supp. 466, 470 (D. Me. 1939), *aff'd*, 113 F.2d 988 (1st Cir.), *cert. denied*, 311 U.S. 705 (1940). The sentence structure and rules of syntax require that the words "interest thereon" modify only "consideration paid" and mandate that interest be calculated only on the consideration. No reasonable construction permits calculating or deducting interest on the "income received." *See Johns Hopkins Univ. v. Hutton*, 297 F.Supp. at 1233. Nevertheless, the Eighth Circuit holds that

> [b]ecause plaintiffs were not deprived of the use of the entire amount of their investments over the ten year period, prejudgment interest is due only on the amount of money they were out-of-pocket at any given time.

Austin II at 959. That interpretation is contrary to the statute's plain meaning.

B.

The Eighth Circuit's Decision Misinterprets Section 28(a).

Section 28(a) provides:

> The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in

> excess of his actual damages on account of the act complained of . . . .

The Eighth Circuit concludes that "a plaintiff can recover no more than his 'net economic loss' " and holds that "net economic loss" is to be equated with "actual damages." *Austin II* at 954; *accord, Salcer v. Envicon Equities Corp.*, 744 F.2d at 940.

That interpretation begs the question of what is intended by the term "actual damages." The sentence structure suggests that Congress meant only to prevent duplicative recovery whenever a plaintiff asserted a state law claim as well as a federal securities law claim.

The first clause of section 28(a) demonstrates that federal remedies do not preempt state remedies. The phrase "actual damages," which is included in the following clause in section 28(a), is designed to prevent a plaintiff from recovering more than once if he pursues both federal and state causes of action.[10] *E.g., Osofsky v. Zipf,* 645 F.2d 107, 111 (2d Cir. 1981).

If this Court is not able to determine the intent from the language of the statute, it is entitled to consider "practical factors" and considerations of "policy" to explicate congressional intent in adopting section 28(a). *See Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, 749 (1975). All practical and policy considerations favor excluding tax benefits from a calculation of damages.

The Eighth Circuit's decision assumes that the tax benefits of investing in a limited partnership are attributable to

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[10]A strict construction of section 28(a), which refers only to "a suit for damages," may preclude any limitation on the equitable remedy of rescission. *See* Note, *Insiders Liability under Rule 10b-5 for the Purchase of Actively Traded Securities,* 78 YALE L. J. 864, 874 n.51 (1969).

the promoter and must be accounted for when damages are calculated. The assumption is false. Tax deductions are allowed by the government, not by the promoter; the benefit, if any, which results from the deductions is based upon the investor's tax situation; nothing is attributable to the promoter. *See Hayden v. McDonald*, 742 F.2d 423, 441-42 (8th Cir. 1984) (concurring opinion). By crediting a promoter who defrauded investors with tax benefits conferred by the government, the Eighth Circuit makes the "government . . . the banker for fraudulent tax shelter activity." *Burgess v. Premier Corp.*, 727 F.2d at 838.

Several harmful effects flow from the Eighth Circuit's decision. First, the Eighth Circuit's decision vitiates the "collateral source" rule. The rule is set forth in RESTATEMENT (SECOND) OF TORTS §920A(2) (1979):

> Payments made to or benefits conferred on [an] injured party from other sources are not credited against the tortfeasor's liability, although they cover all or a part of the harm for which the tortfeasor is liable.

The rule means that

> a benefit that is directed to the injured party should not be shifted so as to become a windfall for the tortfeasor. If the plaintiff was himself responsible for the benefit, as by maintaining his own insurance or by making advantageous employment arrangements, the law allows him to keep it for himself. If the benefit was a gift to the plaintiff from a third party or established for him by law, he should not be deprived of the advantage that it confers. *The law does not differentiate between the nature of the benefits, so long as they did not come from the defendant or a person acting for him.*

Id. comment b (emphasis added). The Eighth Circuit holds that

> the tax benefits of plaintiffs' investments are not a collateral source because "although paid by the government, [they] emanate directly from the tax shelters sought by the plaintiffs and provided by defendants, without which plaintiffs could not have realized any tax benefits. Benefits resulting directly from a transaction under attack must be credited toward the damage award."

Austin II at 956, *quoting Salcer v. Envicon Equities Corp.*, 744 F.2d at 941-42. That analysis misconstrues the nature of a "collateral source."

Every collateral source results directly from the tort or transaction at issue. Health and disability insurance are collateral sources even though they compensate an injured or disabled party for medical expenses and lost income resulting directly from the injury caused by the tortfeasor. *E.g., Dennison v. Head Constr. Co.*, 54 Md. App. 310, 319-22, 458 A.2d 868, 873-74 (1983); *Hueper v. Goodrich*, 314 N.W.2d 828, 830-31 (Minn. 1982). Such insurance is considered to come from a "collateral source" and does not reduce the damage for which the tortfeasor is liable. The rule applies even if the tortfeasor provides the benefits or contributes to a fund which does so. *E.g., Eichel v. New York Cent. R.R.*, 375 U.S. 253, 254-55 (1963); *NLRB v. Gullett Gin Co.*, 340 U.S. 361, 364 (1951); *Kauffman v. Sidereal Corp.*, 695 F.2d 343, 346-47 (9th Cir. 1983); *United States v. Gray*, 199 F.2d 239, 244 (10th Cir. 1952) (government's provision of veterans hospitalization benefits does not diminish portion of damage award against government which constituted cost of treatment).

The proper question is whether the benefit comes from Respondents. Petitioners' tax benefits come from a third party, *i.e.*, the government, and are established by law. R. Thompson, *The Measure of Recovery under Rule 10b-5*, 37 VAND. L. REV. 349, 390 (1984) ("plaintiff who receives

a tax benefit obtains his advantage from the government, not from the defendant"). The tax benefits do not come from Respondents. Any other interpretation would mean that tax benefits which emanate from sources collateral to the investment, *i.e.*, (1) tax incentives created by the government to encourage improvements to real estate and (2) an investor's other taxable earnings, would inure to a defrauder and not to the investor whom the incentives were intended to benefit and who had other earnings. *See Funston v. United States*, 513 F. Supp. 1000, 1010 (M.D. Pa. 1981) ("tax benefit conferred by [the state] is from a collateral source"); *Iowa-Des Moines Nat'l Bank v. Schwerman Trucking Co.*, 288 N.W.2d 198, 205 (Iowa 1980) ("tax saving [is to be] treated as a collateral source"); *Cereal Byproducts Co. v. Hull*, 16 Ill. App. 2d 79, 81, 147 N.E.2d 383, 384, *aff'd*, 15 Ill. 2d 313, 155 N.E.2d 14 (1958) (tax consequences of theft loss treated as being from collateral source); *Lumber Terminals, Inc. v. Nowakowski*, 36 Md. App. 82, 97, 373 A.2d 282, 291-92 (1977) ("[t]axes are strictly between plaintiff as taxpayer and the government as collector, and are of no legitimate concern of the defendants").

Second, the Eighth Circuit's decision does violence to the rule which prohibits fiduciaries from profiting from transactions with their beneficiaries. Here Loftsgaarden committed a massive fraud; yet the Eighth Circuit allows him to take an undisclosed profit, to profit further from the ability to use for twelve years the monies he obtained and to return only a fraction of the original profit.

Third, the Eighth Circuit's decision reduces government revenue. The decision limits the defrauder's liability for damages and thereby reduces the investor's recovery. Be-

cause the investor's recovery would have been taxable, the decision guarantees that the public purse is to be used to provide a profit to fraudulent promoters. *See Western Fed. Corp. v. Davis,* 553 F. Supp. at 821.

Fourth, the Eighth Circuit's analysis accounts for some, but not all, of the tax consequences of the transaction: the tax benefits that a plaintiff receives during the time prior to the limited partnership's insolvency, the taxes paid at the time of insolvency and the assumed taxes to be paid as a result of an award of "damages." The analysis does not take into account the need to amend earlier returns, *see, e.g., Western Fed. Corp. v. Davis,* 553 F. Supp. at 820; *Rhode v. Hershberger Explorations, Inc.,* 349 F. Supp. 993, 994 (D. Minn. 1972), or the government's ability to correct an error made in a prior tax year and to obtain an adjustment of tax liability despite the running of the ordinary period of limitations. *See* 26 U.S.C. §§1311-1314; *but see Austin II* at 956; *Salcer v. Envicon Equities Corp.* 744 F.2d at 942-43.

Finally, the Eighth Circuit's rule creates anomalous damage awards. Investors in different tax brackets, but identically situated in every other way, are to receive damages in differing amounts. Damage awards will vary widely based upon factors which have nothing to do with the investments or with the frauds which occasion the awards if tax consequences must be considered. Even though Randall, Austin and Anderson each invested $35,000.00 and even though none received any cash or cash equivalent as a return on his investment in Alotel Associates, each is to recover a different amount: Randall ($506), Austin ($7,666) and Anderson ($18,790). *Id.* at 961; *compare Hayden v. McDonald,* 742 F.2d at 425 & 439 (56 plaintiffs and presumably 56 different results). Disparate treatment of investors based

upon differences in their taxable income undermines the purposes of the federal securities laws. *See Herman & MacLean v. Huddleston*, 459 U.S. at 390 (defrauded investors are persons whom securities laws seek to protect).

The rule also enables plaintiffs and defendants to increase the amount of damages. Because tax benefits depend upon an investor's "ordinary income" and marginal tax bracket, a plaintiff may manipulate the timing of his receipt of such "ordinary income" and thereby increase his damages. A defendant may also manipulate the amount of tax benefits (and of damages) by his own ability to make elections. S. Banoff, *To What Extent Will Benefits from Tax Shelters be Permitted to Offset Rescission Damages*, 57 J. TAXATION 154, 155-56 (1982).

III.

THE EIGHTH CIRCUIT'S DECISION IS CONTRARY TO PRECEDENT.

A.

The Eighth Circuit's Decision Fails To Defer To This Court's Precedent.

The impact of income taxes on damages available is a recurring subject for this Court's consideration. The applicable principles are the subject of no less than three separate, significant opinions.

In *Hanover Shoe, Inc. v. United Shoe Mach. Corp.*, 392 U.S. 481 (1968), this Court first addressed a party's argument that an adversary's damages must be reduced to the "after-tax profits that [the adversary] failed to receive." *Id.* at 503. This Court held that

> to diminish the actual damages by the amount of taxes that [a plaintiff] would hav paid had it received greater

> profits in the years it was damaged would be to apply a double deduction for taxation, leaving [the plaintiff] with less income than it would have had if [the defendant] had not injured it.

Id. This Court recognized that changing rates of taxation, expired statutes of limitation and difficulties in recomputing taxes which would have accrued over a period of years, stated that

> the rough result of not taking account of taxes for the year of injury but then taxing recovery when received seems the most satisfactory outcome,

id., and held that damages should equal pre-tax profits and that the IRS should be permitted to tax the recovery. *Id.*

In *Norfolk & W. Ry. v. Liepelt,* 444 U.S. 490 (1980), this Court considered the question of whether a refusal of an instruction that any award of damages would not be subject to income taxation was error. *Id.* at 491. This Court recognized an injured individual's after-tax income, not his gross income before taxes, was the relevant factor in calculating the damages sustained by his dependents when he died. *Id.* at 493-94. This Court again recognized the complexities in predicting the many variables; nevertheless, it held that the danger of overcompensation based on an erroneous assumption concerning taxability required the admission of expert testimony concerning income tax liability for future wages and the giving of an instruction that a judgment would not be taxable. *Id.* at 497-98.

In *Jones & Laughlin Steel Corp. v. Pfeifer,* 462 U.S. 523 (1983), this Court offered guidance to those seeking to reconcile its pronouncements in *Hanover Shoe* with those in *Liepelt*. This Court stated that, when the damage award

itself is to be tax-free, the evidence to be considered is that concerning *after-tax* amounts. This Court implied that, when the damage award itself is taxable, evidence of taxes paid or to be paid should be excluded. *Id.* at 547-51.

The Eighth Circuit interprets *Liepelt* to apply to Petitioner's claims for damages and for rescission even though the Eighth Circuit recognized that each would "have to pay taxes on his award." The Eighth Circuit fails to consider *Hanover Shoe* or *Pfeifer*. In doing so, the Eighth Circuit glosses over *Liepelt's* predicate that its holding applies only when an award of damages is not taxable.

B.

The Eighth Circuit's Decision Fails To Defer To Other Courts' Precedent.

Courts had been interpreting the federal securities laws and had been providing remedies for over thirty years before the deductibility of tax benefits surfaced as an issue. *See Cooper v. Hallgarten & Co.*, 34 F.R.D. 482 (S.D.N.Y. 1964). When defendants began to argue that they should be able to reduce a plaintiff's recovery by an amount equal to the tax benefits flowing from an investment, courts uniformly rejected those arguments. *See, e.g., Rhode v. Hershberger Explorations, Inc.*, 349 F. Supp. at 944; *Johns Hopkins Univ. v. Hutton*, 297 F. Supp. at 1232; *Wiesenberger v. W. E. Hutton & Co.*, 35 F.R.D. 556, 557 (S.D.N.Y. 1964); *Cooper v. Hallgarten & Co.*, 34 F.R.D. at 484.

Courts eventually allowed discovery of information concerning tax benefits because of the information's relevance to issues other than damages. *See Smith v. Bader*, 83 F.R.D. 437, 438-39 (S.D.N.Y. 1979); *Sharp v. Coopers & Lybrand*, 83 F.R.D. 343, 352 (E.D. Pa. 1979), *rev'd on other*

grounds, 649 F.2d 175 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982); *Houlihan v. Anderson-Stokes, Inc.*, 78 F.R.D. 232, 233-34 (D.D.C. 1978). Courts which permitted such discovery considered the tax benefits relevant to the issue of valuation of the investment, *see Dupuy v. Dupuy*, 551 F.2d 1005, 1025 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); *Smith v. Bader*, 83 F.R.D. at 439; *accord*, *Berg v. Xerxes-Southdale Office Bldg. Co.*, 290 N.W.2d 612, 615 (Minn. 1980), to the issue of misrepresentation of tax benefits, *Bridgen v. Scott*, 456 F. Supp. 1048, 1062 (S.D. Tex. 1978); *Bayoud v. Ballard*, 404 F. Supp. 417, 426 (N.D. Tex. 1975), to the issue of causation, *see Houlihan v. Anderson-Stokes, Inc.*, 78 F.R.D. at 234, to the issue of reliance, *see Smith v. Bader*, 83 F.R.D. at 439; *Sharp v. Coopers & Lybrand*, 83 F.R.D. at 352, and to the issue of laches. *See Hickman v. Groesbeck*, 389 F. Supp. 769, 780 (D. Utah 1974).

The Eighth Circuit was the first to totally reject existing precedent and to permit defendants to introduce evidence of tax benefits and to require that those benefits offset damages. *Austin I* at 183; Note, *Austin v. Loftsgaarden: Securities Fraud in Real Estate Limited Partnership Investments*, 18 CREIGHTON L. REV. 1140, 1151 (1982) ["*Austin* is without precedent in classifying tax benefits as income within the meaning of section 12(2)"]. Other courts continued to reject the Eighth Circuit's aproach. *E.g.*, *Eisenberg v. Gagnon*, 766 F.2d at 782 (deductability of losses not to be considered in assessing damages); *Western Fed. Corp. v. Erickson*, 739 F.2d at 1444; *Burgess v. Premier Corp.*, 727 F.2d at 837-38; *G & R Corp. v. American Sec. & Trust Co.*, 523 F.2d 1164, 1176 (D.C. Cir. 1975); *Spatz v. Borenstein*, 513 F. Supp. 571, 577-86 (N.D. Ill. 1981);

see also Danzig v. Jack Grynberg & Assoc., 161 Cal. App. 3d 1128, 1139-40, 208 Cal. Rptr. 336, 343-44 (1984), *petition for cert. filed*, 53 U.S.L.W. 3826 (U.S. May 14, 1985) (No. 84-1784) (limited partners' tax consequences irrelevant to their rescissionary recovery based upon misrepresentation); *Harris v. Metropolitan Mall*, 112 Wis. 2d 487, 501-02, 334 N.W.2d 519, 526 & n.21 (1983); *Iowa-Des Moines Nat'l Bank v. Schwerman Trucking Co.*, 288 N.W. 2d at 205; *Borovoy v. Bursar Realty Corp.*, 86 Mich. App. 732, 738, 273 N.W.2d 545, 548 (1979) (tax consequences "do not enter into the computation of damages" under state securities laws); *Cereal Byproducts Co. v. Hall*, 16 Ill. App. 2d at 81, 147 N.E.2d at 384; *cf. Hokama v. E.F. Hutton & Co.*, 566 F. Supp. 836, 847-48 (C.D. Cal. 1983). The Second Circuit, however, adopted the Eighth Circuit's approach. *See Freschi v. Grand Coal Venture*, 767 F.2d at 1050-51; *Salcer v. Envicon Equities Corp.*, 744 F.2d at 940-44.

There was no reason to reject precedent. The Second and Eighth Circuits should have deferred[11] to the rationale and holdings of the earlier cases.

IV.

THE EIGHTH CIRCUIT'S DECISION UNDERCUTS THE DISCLOSURE REQUIREMENTS OF THE FEDERAL SECURITIES LAW.

The Securities Act of 1933 is "a system of full disclosure." T. Hazen, THE LAW OF SECURITIES REGULATION §1.2 at 7 (1985); *see also* 1 L. Loss, SECURITIES

[11]Neither the Second Circuit nor the Eighth Circuit deferred to the expertise of the SEC with respect to the interpretation of the federal securities laws or the expertise of the Tax Division with respect to the interpretation of the internal revenue laws.

REGULATION 184 (2d ed. 1961). The Securities Exchange Act of 1934 is intended to regulate all aspects of the public trading of securities, bars material misstatements and omissions and requires full disclosure. *Id.*

The necessity of full disclosure is implemented by the SEC's examination of registration documents to determine compliance with the securities laws' disclosure requirements, by the SEC's initiation of injunction proceedings, by the SEC's administrative hearing and sanction procedures, by criminal prosecutions and by private litigants' suits for restitution and damages. T. Hazen, THE LAW OF SECURITIES REGULATION §1.3 at 10-11 (1985); 1 L. Loss, SECURITIES REGULATION 302-03 (2d ed. 1961); 2 L. Loss, SECURITIES REGULATION 845-57 (2d ed. 1961); T. Hazen, *Administrative Enforcement: An Evaluation of the SEC's Use of Injunctions & Other Enforcement Methods,* 31 HASTINGS L. J. 427 (1979); *see also United States v. Naftalin,* 441 U.S. 768 (1979); *Red Bank Oil Co.,* 20 S.E.C. 863, 866 (1945).

The Securities Act of 1933 exempts certain securities from its registration requirements because of the "small amount involved"[12] or because of the limited character of the public offering, 15 U.S.C. §77c, and exempts certain transactions because of the nature of the transactions or the participants. 15 U.S.C. §77d. Most limited partnership offerings[13] fall within one or more exemptions.[14] Therefore,

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[12]The total amount invested in limited partnerships in 1983 was estimated to be $8.4 billion. TIME, Nov. 26, 1984, at 26.

[13]In 1980 there were approximately 211,000 real estate limited partnerships in existence. Bureau of Nat'l Affairs, Inc., *Daily Report for Executives* (Feb. 21, 1984).

[14]In a 12 month period during 1975-1976 only 10 limited partnerships were registered with the S.E.C. [1976] 5 FED. SEC. L. REP. (CCH) at 64,214. In a similar period during 1984-1985 less than 60 real estate limited partnerships registered. [1985] 6 FED. SEC. L. REP. (CCH) Br. 5 & 6 at 64,264-77.

the SEC has no opportunity to examine documents prior to sale. Because neither SEC nor the Department of Justice has the resources to police all of the fraudulent activity by organizers of limited partnerships,[15] the primary tool in enforcing the disclosure requirements is the private civil action. Note, *Real Estate Limited Partnerships & Allocational Efficiency: The Incentive to Sue for Securities Fraud,* 63 VA. L. REV. 669, 670-71 (1977).

The incentive to make full disclosure is in direct relation to the likelihood and risk of a successful suit. *Id.* at 671. The Eighth Circuit's decision makes it unlikely that defrauded investors will sue and minimizes the risk to the fraudulent promoter in the unlikely event that they do sue. *Id.* at 671-72. One commentator described the Eighth Circuit's message to potential promoters:

> Relax. Should a violation of the securities law occur, promoters in the Eighth Circuit apparently need only assure themselves that the investors get a large enough tax deduction.

Note, *Austin v. Loftsgaarden: Securities Fraud in Real Estate Limited Partnership Investments,* 16 CREIGHTON L. REV. 1140, 1152 (1983).

Allowing the Eighth Circuit's decision to stand encourages thousands of promoters to omit or to misrepresent information material to potential investors. Like Loftsgaarden, those promoters will hope to pocket in excess of $100,000, to keep all of the money for twelve years and then to return less than $30,000. The decision will discourage the tens of thousands of investors who look at Randall and see only a man who invested $42,500 as a result of a fraud, who spent thousands of dollars trying to salvage his investment and

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[15]Fraud continues to grow despite the efforts of federal and state enforcement agencies. *Washington Post,* Jun. 4, 1984, at A-11.

who was left with nothing but an expenditure of almost ten years and additional thousands of dollars in attorney's fees in pursuit of his recovery of $506.

This Court must insist on the disclosure required by statute. To do so, it must insure the continued viability of the express and implied remedies for violations of the securities laws' disclosure requirements. To do otherwise is to undercut the protective purpose of the securities laws. *See* R. Thompson, *The Measure of Recovery under Rule 10b-5*, 37 VAND. L. REV. 349, 390 (1984) ("[f]ocusing on the defendant and resolving doubts against the party committing the fraud is consistent . . . with the dual deterrent/compensatory purposes of the federal securities laws" and requires that there be no deduction for tax benefits); *United States v. Naftalin*, 441 U.S. at 774-77.

CONCLUSION

For the foregoing reasons, a writ of certiorari should issue to review the judgment and opinion of the Eighth Circuit.

Respectfully submitted,

/s/ Robert Arthur Brunig
O'CONNOR & HANNAN
3800 IDS Tower
80 South Eighth Street
Minneapolis, Minnesota 55402
Telephone: (612) 343-1200
Attorney for Petitioners

Of Counsel:
Terence M. Fruth
FRUTH & ANTHONY, P.A.
1300 International Centre
900 Second Avenue South
Minneapolis, Minnesota 55402
Telephone: (612) 349-6969

September 23, 1985.

85-519

No. ———

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

October Term, 1985

DR. WILLIAM C. RANDALL, DR. ROGER E. AUSTIN, DR. TOM W. ANDERSON and DR. MYREL A. NEUMANN,

Petitioners,

v.

B. J. LOFTSGAARDEN; ALOTEL INCORPORATED, a Minnesota corporation; PROPERTY DEVELOPMENT AND RESEARCH COMPANY, a Minnesota corporation; and 2361 BUILDING CORPORATION, a Minnesota corporation,

Respondents.

APPENDIX

Robert Arthur Brunig
O'CONNOR & HANNAN
3800 IDS Tower
80 South Eighth Street
Minneapolis, Minnesota 55402
Telephone: (612) 343-1200
Attorney for Petitioners
Of Counsel:
Terence M. Fruth
FRUTH & ANTHONY, P.A.
1300 International Centre
900 Second Avenue South
Minneapolis, Minnesota 55402
Telephone: (612) 349-6969

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APPENDIX A

UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

No. 84-5053
No. 84-5058
No. 84-5059

Dr. Roger E. Austin, Dr. Tom W. Anderson, Dr. Myrel A. Neumann, and Dr. William C. Randall,

Appellees,

v.

B. J. Loftsgaarden; Alotel Incorporated, a Minnesota corporation; Property Development and Research Company, a Minnesota corporation and 2361 Building Corporation,

Appellants.

Appeals from the United States District Court for the District of Minnesota

Submitted: January 17, 1985 Filed: July 16, 1985

Before LAY, Chief Judge, and HEANEY, BRIGHT, ROSS, McMILLIAN, ARNOLD, JOHN R. GIBSON, FAGG, and BOWMAN, Circuit Judges.

PER CURIAM.

This en banc hearing arises from a retrial on the issue of damages ordered by this Court in *Austin v. Loftsgaarden*, 675 F.2d 168 (8th Cir. 1982) (*Austin I*). In *Austin I*, we affirmed the jury's verdict that Loftsgaarden and three of his closely-held corporations (hereinafter Loftsgaarden) violated state and federal securities laws, but held that the district court erred in ruling that the plaintiff-investors' rescissionary damages could not be reduced by the "tax shelter"[1] benefits they received as a result of their investments. Thereafter, we denied plaintiffs' petition for rehearing or rehearing en banc.

On remand, the district court deducted plaintiffs' tax benefits from their damage awards and both sides appeal. After oral argument before a panel of this Court, the panel issued an order setting two issues for en banc consideration: First, whether *Austin I* should be reconsidered as it relates to the offset of tax benefits from rescissionary damages awarded in a private securities fraud action involving an investment that was structured and marketed as a tax shelter; and second, assuming that *Austin I* was properly decided, what is the proper measure of plaintiffs' rescissionary damages?

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[1]In *Austin I*, we defined "tax shelters" as investments which allow the investor

> to offset certain "artificial losses" (that is noneconomic losses but losses which are available as deductions under the present tax laws) not only against the income from those investments but also against the [investor's] other income, usually from his regular business or professional activity.

675 F.2d at 183 (citing Staff of Joint Comm. on Internal Revenue Taxation, 94th Cong., 1st Sess., *Overview of Tax Shelters* 1 (Comm. Print 1975)).

FACTS

The facts in this case are set forth in detail in *Austin I*, 675 F.2d at 173-76. We briefly review them here.

Plaintiffs Austin, Anderson, Neumann and Randall, invested over $152,000 in Alotel Associates (hereinafter Associates), a limited partnership organized by defendant B. J. Loftsgaarden to help finance the building and operation of a Ramada Inn in Rochester, Minnesota. Loftsgaarden's offering memorandum claimed that purchasers of the limited partnership interests would receive substantial tax benefits during the first three years of their investments and thereafter would share in the hotel's projected profits.

The Rochester Ramada opened several months behind schedule in 1974 at a construction cost substantially in excess of that projected. Thereafter, the hotel incurred significant operating losses and Loftsgaarden requested the limited partners to extend to Associates several large loans to prevent insolvency. The limited partners hired a lawyer and an accountant to investigate Loftsgaarden's stewardship of the project, which revealed that Loftsgaarden had knowingly committed several frauds on the limited partners. Although Loftsgaarden resigned as general partner and the limited partners made additional loans,[2] the partnership ultimately defaulted on its obligations and the hotel was foreclosed upon.

The four plaintiffs[3] then filed this securities fraud action

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[2]The jury found that these advances were not induced by any misrepresentations by Loftsgaarden and thus the plaintiffs could not recover them.

[3]The numerous other limited partners were initially parties to this action but subsequently dropped their claims.

against Loftsgaarden. The jury found that Loftsgaarden had violated "section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b); Rule 10b-5, 17 C.F.R. 240.10b-5; the antifraud provision of the Minnesota Securities Act, Minn. Stat. §§ 80A.01, *et seq.*, 80A.23; and [had committed] common law fraud. The jury rendered an advisory verdict—in which the district court concurred—that defendants were liable for violating § 12 (2) of the Securities Act of 1933. 15 U.S.C. § 77*l*(2)." *Austin I*, 675 F.2d at 172 (footnotes omitted.) The court applied a rescissionary measure of damages in the amount of the consideration each plaintiff paid for his limited partnership unit or units, prejudgment interest from the date of purchase, and attorneys' fees for plaintiffs Randall and Neumann for a total judgment of $273,720.

We affirmed the findings of liability, but vacated the award of damages and remanded to the district court, stating "the court committed reversible error in refusing to allow proof of any economic benefits received by plaintiffs on account of the investment and in failing to instruct the jury that the damage award must be reduced by any value shown to have been received by plaintiffs." *Austin I*, 675 F.2d at 181.

On remand, the district court awarded to plaintiffs damages in the amount of their consideration paid, with eight percent interest thereon, less tax benefits received, for a total amount as follows. Anderson, $35,172; Austin, $31,277; Neumann, $39,371; and Randall, $31,569. It also granted attorneys' fees under Minn. Stat. § 80A 23, subd. 2 as follows: Anderson, $0; Austin, $0; Neumann, $29,000; and Randall, $20,000. In addition, the court granted costs of $5,321.83 to Austin, Anderson and

Neumann and $2,955.49 to Randall. We now consider the two issues raised before the Court en banc.

DISCUSSION

I. *Should Austin I be reconsidered as it relates to the offset of tax benefits from rescissionary damages awarded in a private securities fraud action involving an investment structured and marketed as a "tax shelter"?*

The starting point for our analysis is that the petition for rehearing or rehearing en banc in *Austin I* was denied, 675 F.2d at 168, and that, accordingly, its holdings are now law of the case. As we stated in *Otten v. Stonewall Ins. Co.*, 538 F.2d 210 (8th Cir. 1978):

> Law of the case principles have been stated with clarity and consistency in this court over a long period of time. "This court has repeatedly held that the decision on former appeal is the 'law of the case' on a question presented in that former appeal, unless the evidence introduced at the subsequent trial is substantially different from that considered on the first appeal, and must be followed in all subsequent proceedings in such case in both district and appellate courts unless that decision is clearly erroneous and works manifest injustice. * * * While this rule of practice is not a limit of power, it is nevertheless a salutary one, and should be departed from only after careful consideration of situations arising in specific cases."

Id. at 212 (citations omitted).

The appellees contend that the damages holding in *Austin I* is "clearly erroneous" and works a "manifest injustice" and thus should be reversed. After a careful review

of *Austin I*, the relevant cases, the arguments of the parties and the Tax Division of the Justice Department and the Securities and Exchange Commission, appearing as *amicus curiae*, we abide by our previous decision. In doing so, we note that since our opinion in *Austin I*, the United States Court of Appeals for the Second Circuit has substantially adopted the views that we expressed in that case. *Salcer v. Envicon Equities Corp.*, 744 F.2d 935 (2d Cir. 1984).[4]

Our decision in *Austin I* was based on the principle that: "[D]amages for securities fraud are determined in accordance with the extent to which false and misleading information actually harmed the complaining party." *Austin I*, 675 F.2d at 180 (citation omitted). We noted that for this reason, the courts typically used the out-of-pocket measure of damages,[5] but that where a rescilssionary measure of damages is applied, the "actual damages principle requires that a rescissionary * * * award be reduced by any value received as a result of the fraudulent transaction." *Austin I*, 675 F.2d at 181 (citation omitted). We held that this principle applied not only to the 1933 Act claims and the claim under Minn. Stat. § 80A.23(2),[6] (both of which explicitly

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[4]*But cf. Burgess v. Premier Corp.*, 727 F.2d 826 (9th Cir. 1984) (applying different rule in case of actual rescission).

[5]The parties are in dispute over whether the out-of-pocket measure of damages would provide recovery similar to that approved here. *See Salcer*, 744 F.2d at 940 n.5, Brief of SEC at 22-23. We need not address this issue, however. *Austin I* limited its holding to tax shelter cases where a recissionary measure of damages is applied. 675 F.2d at 183.

[6]In *Hayden v. MacDonald*, 742 F.2d 423 (8th Cir. 1984), plaintiffs brought claims under Minn. Stat. § 80A.23(1), which provides that, in an action for rescission and restitution based on the nonregistration of securities in Minnesota, "the purchaser shall be entitled to recover the consideration paid for the security * * * less the amount of any income received on the security." Because the Minnesota courts had not directly addressed the issue, we deferred to the district court's interpretation of "income received" as not including tax benefits. *Id.* at 440-41. We now overrule that decision.

limit damages to the "actual damages" sustained), but also to the common law fraud claim[7] and the claim un-

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We do not believe that Minnesota could have intended to treat fraudulent sellers more kindly than those who have simply neglected to register their securities. Although the phrase "actual damages" does not appear in subsection (1), the principle that a plaintiff should not be placed in a better position than he would have been in but for the fraud — the principle, in other words, that no recovery in excess of actual damages should be permitted — is plainly implicit in that provision. In actions for rescission based on sales of unregistered securities, the statute says, "the amount of any income received on the securities" is to be subtracted from "the consideration paid for the security together with interest" in computing damages.

Moreover, to allow greater recoveries under subsection (1) than under subsection (2) leads to results that are anomalous in the extreme. Subsection (1) governs not only simple actions for sale of unregistered securities (arising under Minn. Stat. §80A.08), but also actions for misrepresenting that registration of a security means that state officials are recommending that security (a practice made unlawful by Minn. Stat. §80A.18). Otherwise, a defendant who tells a buyer that the filing of a registration statement means that the Commissioner of Commerce is recommending purchase of the security registered would be liable for the full amount of consideration paid, and would receive no credit for tax benefits conferred on the buyer, however substantial. But a defendant who commits some other kind of fraud, however flagrant, would receive such credit, solely because the action against him arises under §80A.23(2) instead of §80A.23(1). The Minnesota Supreme Court, of course, can resolve this matter authoritatively and have the last word on the subject.

Our brother Heaney, *post* p. 26, takes the position that "it is bad policy" to reach the *Hayden* issue because it "was not presented to us by the parties" and "we need not decide" it. We would like to explain briefly why we disagree with this statement. The Court en banc was convened to decide whether we should adhere to the panel's decision in *Austin I*. Plaintiffs, seeking disapproval of *Austin I*, argued that it was inconsistent with *Hayden*. We agree. The logical implications of *Austin I*, which is now approved by the Court en banc, are completely inconsistent with *Hayden*, for reasons we have given. The Court en banc is convened infrequently, though perhaps not infrequently enough, and we believe it is good judicial policy to use those infrequent occasions to bring consistency to our case law. If we were to leave *Hayden* on the books, without indicating one way or the other whether it is still good law, we would almost guarantee that the Court en banc would have to meet again when the *Hayden* issue arose, unless, of course, the Supreme Court of Minnesota had, in the meantime, resolved the question, an event the likelihood of which we have no way of estimating. For these reasons, we believe it is a wise use of the Court's time and energy to say now that *Hayden* is inconsistent with the position we now take in *Austin II*, and, therefore, to state unequivocally that *Hayden* is abandoned.

[7] In *Berg v. Xerxes-Southdale Office Bldg. Co.*, 290 N.W.2d 612, 615 (Minn. 1980), the Court implied that tax benefits must be considered in determining damages under a Minnesota common law securities fraud

der section 12(2) of the 1934 Act. Although the 1934 Act does not explicitly limit rescissionary damages to "actual damages" sustained, we noted that:

> Under § 12(2), the defendant guilty of prospectus fraud shall be liable to plaintiff, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, *less the amount of any income received thereon,* upon the tender of such security, or for damages if he no longer owns the security.

Id. at 181 (emphasis in original).

Because we found that section 12(2) implicitly incorporates the "actual damages" principle and that the words "income received" should be construed as including the tax benefits bargained for and received in the special case of a tax shelter investment, we concluded that the plaintiffs' damages must be reduced by the tax benefits they received.

The plaintiffs now contend that we should reconsider both of the above findings of *Austin I*. First, they argue that the "actual damages" language in section 28(a) of the 1934 Act does not justify subtracting tax benefits from awards under section 12(2) of the 1933 Act because section 28 (a) applies only to the 1934 Act and the words "actual damages" do not appear anywhere within the 1933 Act. We reject this contention. Although the words "actual damages" do not appear in the 1933 Act,

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claim, at least where the case involves a limited partnership offering which includes the promise of artificial tax savings. 290 N.W.2d at 615-16. *See* note 4, *supra. See also Weise v. Red Owl Stores, Inc.*, 286 Minn. 199, 175 N.W.2d 184, 187 (1970) (the out-of-pocket rule also governs an award of damages for common law securities fraud).

the courts have nonetheless applied the actual damages principle of section 28(a) to bar punitive damages[5] under section 17(a) of the 1933 Act, *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276, 1278, 1283-86 (2d Cir.), *cert. denied*, 397 U.S. 913 (1970), and have construed the rescission and restitution remedy provided by section 12 (2) as substantially equivalent to the damages permitted under section 28 (a). *Cf. Affiliated Ute Citizens v. United States*, 406 U.S. 128, 155 (1972). The goal of rescission under section 12 (2) is to return the parties to the status quo *ante*, "and hence a plaintiff can recover no more than his or her 'net economic loss,' " *i.e.*, "actual damages." *Salcer*, 744 F.2d at 940; *Austin I*, 675 F.2d at 181; *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 49 n.22 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978).

We also reject plaintiffs' contention that tax savings are neither "income" nor are they "received" within the meaning of section 12 (2). They cite *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975) in support of their argument, but that case is inapposite. The plaintiffs in *United Housing* were tenants who were required to purchase refundable non-interest bearing shares in a non-profit housing cooperative in order to rent a low-cost apartment. After a rent increase was imposed to meet costs, plaintiffs brought fraud claims under the Securities Act of 1933 and the Securities Exchange Act of 1934, alleging that they were misled in the purchase of the shares by misrepresentation in the cooperative's information bulletin.

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[5]We reject the SEC's argument that the actual damages principle is only intended to prohibit awards of punitive damages or duplicate state and federal recoveries based on the same conduct. *See also Shapiro v. Midwest Rubber Reclaiming Co.*, 626 F.2d 63, 70 (8th Cir. 1980), *cert. denied*, 499 U.S. 1079 (1981).

The Court looked to "economic reality," 421 U.S. at 848, in determining that the shares were not securities. It noted that the plaintiffs' purchase of the shares was motivated by a desire to obtain housing, not to make a profit in the sense of a "return on investment." The Court was not persuaded that the plaintiffs expected a profit on their non-interest bearing refundable shares (which were akin to a "security deposit") simply because they were able to reduce their taxes by deducting that portion of their monthly rental charges which were applied to interest on the mortgage. 421 U.S. at 855. The Court noted that "[e]ven if the tax deductions were considered profits, they would not be the type associated with a security investment since they do not result from the managerial efforts of others." *Id.* 421 U.S. at 856 n.20.

United Housing is not only distinguishable on its facts; if anything, its analysis tends to support our position in *Austin I*. Like the *United Housing Court*, the *Austin I* Court looked to "economic reality" in considering the tax aspects of a tax shelter investment.[9] Additionally, unlike the marginal tax benefits referred to in *United Housing*, the tax benefits in the case at hand were a primary motivation behind the investment and resulted from Loftsgaarden's efforts in structuring and operating the partnership to take advantage of relatively complicated tax rules. *See Salcer*, 744 F.2d at 941 ("plaintiffs' argument

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[9] *See also Salcer*, 744 F.2d at 941 ("To ignore the state's tax benefits actually realized by the plaintiffs would be unrealistic."); *Bridgen v. Scott*, 456 F. Supp. 1048, 1061 (S.D. Tex 1978) ("Requiring the jury or this Court to try this case without reference to the tax consequences of the transaction would be requiring the jury and this Court to live in an artificial 'never-never' land. The plaintiffs' position that the tax consequences of this transaction should be ignored is simply not realistic and is tantamount to requesting this Court and the jury to try this case blindfolded.").

that defendants are not entitled to 'credit' for the tax benefits because the latter were 'provided' by the government rather than by the defendants must be rejected * * * [T]hat the tax benefits were paid by the government rather than by the defendants does not lessen the defendants' role in securing them.").

In any event, *Austin I* did not hold that tax benefits received are a form of income in a strict accounting sense.[10] Rather, we held that section 12(2)'s requirement that "income received" be deducted in determining rescissionary damages simply reflected that all economic benefits bargained for and received must be deducted from plaintiffs' damages because "the strictly compensatory nature of damages awarded in private securities fraud actions requires that such value be taken into account in determining whether and to what extent damages were inflicted upon plaintiffs." *Austin I*, 675 F.2d at 183.

The plaintiffs claim that their tax benefits have not been "received" must also be rejected because they have stipulated that they have received permanent tax benefits from their investments in Associates. Similarly, we reject the contention of the Tax Division and the SEC that plaintiffs' tax benefits "may" prove to be illusory because they "may" experience recapture upon sale or other disposition of the hotel. All of the plaintiffs in this case have already experienced all possible recapture when the hotel was foreclosed upon in 1978 We also reject, as without a factual basis, the Tax Division's claim that "it is far from clear that all the proper income recognition and recapture provisions were taken into account." Brief of

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[10]Loftsgaarden, in an apparent change in strategy, now contends that the tax benefits are not income received but are instead a return of consideration. We address this claim *infra*.

Tax Division at 11. All of the plaintiffs' tax returns from the relevant tax years have already been audited and are now closed.

We also find without merit the Tax Division's claim that, under the "tax benefit rule," the plaintiffs, upon receiving rescissionary damages, will have to amend their prior tax returns to eliminate all tax benefits previously received as a result of their investments in Associates. The "tax benefit rule" does not require elimination of tax benefits already received. *See Hayden v. McDonald,* 742 F.2d at 440. Rather, it provides that a taxpayer who claims a deduction resulting in a tax benefit one year and who later obtains a recovery or repayment in a later year must include the recovery or repayment as ordinary income in the year of recovery.[11] *See Hillsboro National Bank v. Commissioner,* 460 U.S. 370, 103 S. Ct. 1134, 75 L.Ed.2d 130, 142-44 (1983); *Salcer,* 744 F.2d at 943; 1 Mertens, *Law of Federal Income Taxation,* § 7.34 at 7-115, § 7.37 at 7-130. We need not address the contention of the Tax Division and the SEC that the tax consequences of the rescissionary award will "wash out" any prior tax savings, because we are not presented with such a situation in this case.

The plaintiffs next contend, with support from the SEC, that the collateral source rule requires that Section 12(2) awards not be reduced by tax benefits. This rule "prohibits taking into consideration benefits received from third parties as the result of wholly separate and distinct transactions, such as those received under insur-

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[11]We need not decide whether a different situation might exist in a case involving actual rescission. *See Salcer,* 744 F.2d at 943; *Burgess v. Premier Corp.,* 727 F.2d at 838.

ance policies negotiated independently." *Salcer*, 744 F.2d at 941. We agree with the *Salcer* Court that the tax benefits of plaintiffs' investments are not a collateral source because "although paid by the government, [they] emanate directly from the tax shelter sought by the plaintiffs and provided by defendants, without which plaintiffs could not have realized any tax benefits. Benefits resulting directly from a transaction under attack must be credited toward the damage award." *Id.* at 941-42.

For similar reasons, we reject plaintiffs' claim that we should ignore their tax benefits because otherwise the defendants will unjustly "retain" the consideration previously paid by the plaintiffs. First of all, it does not appear that the defendant has "retained" any of plaintiffs' consideration; rather these monies were paid to the partnership and were invested in the project. Moreover, the purpose of the private civil remedies provided by the federal and relevant Minnesota securities laws is not to penalize defendants, but to compensate plaintiffs for any actual monetary loss. *See id.* at 941. This actual monetary loss cannot be determined without reference to tax benefits bargained for and received.

We also reject the similar argument of *amici* that deducting tax benefits from damages will deprive the government of just tax revenues. The government is entitled only to those revenues which are authorized under the tax laws. These laws create incentives for real estate projects to further public policy objectives, such as the creation of employment, enhancement of the real estate tax base and the local business climate. The Rochester Ramada project met all of the tax code criteria and thus generated the income tax benefits which the plaintiffs enjoyed. This case is therefore very similar to *Salcer*, where the Court stated:

> Nor can we agree with the notion that our ruling makes "the government the banker for fraudulent tax shelter activity," *Burgess v. Premier Corp., supra,* 727 F.2d at 838. As Judge Broderick noted, there was no such activity in this case; the fraud, if any, pertained only to the investment aspects of the Greenspoint Project. The government got the residential development that it hoped to encourage by offering the tax benefits taken by the plaintiffs. Thus, it is "banking" precisely what it agreed to "bank." There is no suggestion that the project did not meet federal requirements as a viable housing development entitling its owners to tax benefits.

Id. at 941.

There is no legal justification for awarding a party damages to which he is not entitled merely to provide revenue for the government to tax.

Next, we reject plaintiffs' claim that the consideration of tax benefits in determining rescissionary damages in a tax shelter case creates unnecessary complexities. Our opinion in *Austin I,* 675 F.2d at 183, deals at length with this contention. We noted that "the complexity of evidence relating to plaintiffs' tax savings is not a viable reason for precluding such evidence in light of *Norfolk & Western R. Co. v. Liepelt,* 444 U.S. 490, 100 S. Ct. 755, 62 L.Ed 2d 689 (1980)." *Id.* We cannot agree that the retrial of the damages issue on remand reflects such complexity that *Austin I* must now be reversed.

Finally, plaintiffs and the SEC[12] contends that *Austin I's*

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[12]The SEC also argues that tax benefits should be considered in computing prejudgment interest, but not in computing damages. We agree with the *Salcer* Court, 744 F.2d at 942, that this argument "is so unrealistic and disproportionate as to border on the frivolous" and "must be rejected out of hand."

tax benefit offset rule discourages private enforcement of the antifraud provisions of the federal securities laws in an area in which the Commission itself is unable to devote substantial resources.[13] While it is unclear that this will be the result of the offset rule because most defrauded tax shelter investors will still be able to obtain at least some damages, we agree with the *Salcer* Court that it is for the legislature, not for the courts, to authorize the award of more than "actual damages" in order to encourage the filing of private damage actions. *Salcer*, at 941. *See also e.g., Alyeska Pipeline Service Co. v. Wilderness Society*, 421 U.S. 420 (1975) (shifting of attorneys' fees by court to create incentives is impermissible).

In sum, we affirm the holding of *Austin I* "that in a private securities fraud action involving an investment structured and marketed as a tax shelter, where a rescissory measure of damages is applied, evidence of any benefit derived by the plaintiff/investor via tax savings must be permitted." *Austin I*, 675 F.2d at 183-84.

II. *How should the plaintiffs' rescissory damages be computed?*

On remand, the district court first determined the amount of permanent tax benefits received by each of the plaintiffs as follows: Anderson, $29,615.00; Austin, $33,330.00; Neumann, $57,014.00; Randall, $36,404.00. The parties do not contest this finding; accordingly, we adopt these figures as the amount of tax benefits received by each plaintiff.

The court then determined that each plaintiff was en-

[13]Most tax shelter securities are sold in private offerings exempt from the registration requirements of the 1933 Act.

titled to prejudgment interest at the rate of eight percent simple interest[14] under section 12(2) of tht 1933 Act. The interest rate has been approved by the panel opinion announced today along with the *en banc* opinion.

The court then determined rescissory damages in accordance with the specific language of section 12 (2); cordance with the specific language of section 12(2); less the amount of any income received thereon." Under the district court's amended determination, this computation produced the following results:

Plaintiff Austin	
Consideration paid June 6, 1973:	$35,000
Simple interest at 8% to February 22, 1984:	$31,277
Subtotal	$64,610
Minus tax benefits:	— $33,333
Total damages:	$31,777
Plaintiff Neumann	
Consideration paid August 21, 1973:	$35,000
Plus consideration paid October 19, 1973:	$17.500
Simple interest at 8% to February 22, 1984:	$43,885
Subtotal	$96,385
Minus tax benefits:	— $57,014
Total damages:	$39,371

[14]The court originally ordered compound interest but amended its judgment by ordering simple interest.

Plaintiff Randall	
Consideration paid November 13, 1973:	$35,000
Simple interest at 8% to February 22, 1984:	$28,770
Plus consideration paid 1975:	$2,512
Simple interest at 8% to February 22, 1984:	$1,691
Subtotal	$67,973
Minus tax benefits:	— $36,404
Total damages	$31,569
Plaintiff Anderson	
Consideration paid June 2, 1973:	$35,000
Plus interest at 8% to February 22, 1984:	$29,787
Subtotal	$64,787
Minus tax benefits:	— $29,615
Total damages:	$35,172

Although the parties and *amici* suggest several variations from this damage computation formula, we believe they raise only three serious contentions. First, defendant Loftsgaarden argues that, under the section 12(2) damage computation formula, tax benefits are a return of "consideration paid" and thus must be deducted from consideration paid before adding on interest. As the district court noted, this course would drastically reduce the awards to Anderson and Austin and eliminate the awards to Neumann and Randall. We agree with the district court that this approach must be rejected. As we noted

previously, *Austin I* did not indicate that tax benefits should be treated as a return of consideration. Instead, in holding that tax savings must be subtracted from damages we quoted section 12(2) and italicized the phrase, *"less the amount of any income received thereon." Austin I*, 675 F.2d at 181. Similarly, in *Hayden v. McDonald*, 742 F.2d at 441, we characterized *Austin I* as "implicitly construing the 'income' language in a federal securities statute to include tax considerations." At least one commentator has also characterized *Austin I* as "classifying tax benefits received by the plaintiff as 'income' within the meaning of section 12(2) of the 1933 Act." Note, *Austin v. Lotfsgaarden, etc.*, 16 Creighton L. Rev. 1140, 1151 (1983). *Cf.* S. Banoff, *"To What Extent Will Benefits From Tax Shelters Be Permitted to Offset Rescission Damages?,"* 57 J. Tax'n 154, 156 (1980).

Additionally, whether or not tax benefits may be considered "income" in a strict accounting sense, tax benefits are far more dissimilar to "consideration." Moreover, although we find that section 12(2)'s language "income *received* thereon" may properly be construed as including tax benefits bargained for and received, we do not agree that tax benefits can be considered a "return" of consideration.

Finally, treating tax benefits as consideration returned would, even under Loftsgaarden's calculations, mean that the plaintiffs would not be compensated for their actual damages. For example, using Loftsgaarden's calculations of plaintiff Neumann's net interest cost (as we explain further below), he would receive no damages even though

he suffered net economic loss of at least $992.[15] Loftsgaarden no doubt prefers the zero judgment figure to the $992 figure, in part because this would lend substantial support to his argument before the panel that Neumann is not entitled to the $29,000 in attorneys' fees granted by the district court. In short, we cannot agree that the district court erred in refusing to treat the tax benefits as a return of consideration for purposes of determining the order of computation under the formula set forth in section 12 (2).

Loftsgaarden next contends that the district court erred in awarding prejudgment interest on the total amount of consideration paid by each plaintiff from the date paid until February 22, 1984, rather than awarding interest only on the amount of money which each plaintiff was "out-of-pocket" during each year of the investment. We agree. The goal of prejudgment interest is to compensate plaintiffs for the loss of the use of their money. *See Cant v. A. C. Becker & Co.*, 384 F.Supp. 814 (N.D. Ill. 1974);

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[15]Loftsgaarden's calculations indicate that Neumann invested $52,500, lost $5,506 in opportunity cost on the use of his money at 8% simple interest and received $57,014 in tax benefits for a net economic loss of $992. By subtracting the $57,014 in tax savings from the $52,500 consideration paid, before considering Neumann's opportunity cost in that he did not receive the $57,014 back until several years after he invested the $52,500, Neumann receives zero in damages.

Loftsgaarden cites *Johns Hopkins University v. Hutton*, 297 F. Supp. 1165, 1233 (D. Md. 1968), *aff'd in part and rev'd in part on other grounds*, 422 F.2d 1124 (4th Cir. 1970) as support, but that case is inapposite. In that case, the court treated "repayment of *principal*" as a return of consideration. A repayment of principal bears no similarity to tax benefits received. However, even if we were to change *Austin I's* rationale and treat tax benefits as a return of consideration, plaintiffs at minimum would be entitled to their net opportunity cost in damages. This could be done by reducing the amount of the tax benefits received to present value at the time of the investment using, for purposes of this opinion, the 8% discount rate. We prefer, however, to affirm the district court's treatment of tax benefits as "income received."

Chris-Craft Industries, Inc. v. Piper Aircrafter Corp., 384 F.Supp. 507, 527 (S.D.N.Y. 1974), *modified*, 516 F.2d 172 (2d Cir. 1975), *rev'd on other grounds*, 430 U.S. 1 (1977). Because plaintiffs were not deprived of the use of the entire amount of their investments over the ten year period, prejudgment interest is due only on the amount of money they were out-of-pocket at any given time. *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1307 (2d Cir. 1973) (prejudgment interest should be computed on the "net difference between value of assets given and value received"); *Murphy v. Cady*, 30 F. Supp. 466, 470 (D. Me. 1939), *aff'd*, 113 F.2d 988 (1st Cir.), *cert. denied*, 311 U.S. 705 (1940) (reaching similar result by determining that plaintiff was entitled under section 12(2) "to recover the amount paid for [the security] with interest, less the amount received with interest").

Loftsgaarden has submitted what we find is a reasonably accurate determination of the net interest costs incurred by the plaintiffs taking into account the amount of money invested, and the tax benefits received by each plaintiff during each year of their investment in Associates. These calculations, prepared by John M. Carlson, Certified Public Accountant, are as follows:[10]

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[10]These calculations are based on the eight percent rate affirmed by the panel opinion attached at the end of this opinion. These calculations take into account recapture and also net out plaintiffs' interest costs by their interest gains on the amount of ordinary income above the amount of their investments retained in each year because of tax benefits conferred by their investments in Associates. These calculations also assume that each plaintiff did not receive the tax benefits until April 15 of each year, when their tax returns were due. Although this does not take into account the benefits of potential reduced payments of estimated tax, we find that the calculations present a reasonably accurate and straightforward method of determining net prejudgment interest costs.

RANDALL

	Invested	Net Reduction (increase in) Tax Liability Current	Carryback	Balance	Days	Interest Cost (earned) at 8% annum
11/13/73	35,000			35,000	153	1,174
4/15/74		4,499		30,501	365	2,440
4/15/75		21,268		9,233	365	739
4/15/76		10,481		(1,248)	365	(100)
4/15/77		10,272		(11,520)	365	(922)
4/15/78		7,297		(18,817)	365	(1,505)
4/15/79		(21,855)		3,038	365	243
4/14/80		4,442		(1,404)	1,339	(412)
12/15/83	35,000	36,404		(1,404)	3,682	1,657

ANDERSON

6/ 2/73	35,000			35,000	317	2,432
4/15/74		11,221		23,779	365	1,902
4/15/75		17,149		6,630	365	530
4/15/76		10,987		(4,357)	365	(349)
4/15/77		11,011		(15,368)	365	(1,229)
4/15/78		7,972		(25,340)	365	(1,867)
4/15/79		(35,974)		(12,634)	365	1,011
4/15/80		7,249		5,386	1,339	1,580
12/15/85	35,000	29,615		5,385	3,846	4,010

NEUMANN

8/21/73	35,000			35,000	58	445
10/19/73	17,500			52,000	178	2,048
4/15/74		19,560		32,940	365	2,635
4/15/75		9,858		23,092	365	1,847
7/15/75			3,677	19,415	91	387
4/15/76		14,431		4,984	274	299
4/15/77		4,888		96	365	8
7/15/77			77	19	91	
4/15/78		9,000		(8,981)	274	(539)
4/15/79		(5,236)		(3,745)	365	(299)
4/15/80		769		(4,514)	1,339	(1,325)
12/15/83	52,500	53,260	3,754	(4,514)	3,765	5,506

AUSTIN

6/26/73	35,000			35,000	293	2,248
4/15/74		13,066		21,934	365	1,755
4/15/75		19,259		2,675	365	214
4/15/76		10,863		(8,188)	365	(655)
4/15/77		3,324		(11,512)	365	(921)
4/15/78		7,646		(19,158)	365	(1,533)
4/15/79		(26,274)		7,116	365	569
4/15/80		5,449		1,667	1,339	489
12/15/83	35,000	33,333		1,667	3,822	2,166

SUMMARY

	Invested	+	Interest Cost	−	Tax Benefit	=	Damages and Interest
Randall	35,000		1,657		36,404		253
Anderson	35,000		4,010		29,657		9,395
Neumann	52,500		5,506		57,014		992
Austin	35,000		2,166		33,333		3,833

Next, both plaintiffs and defendants contend that in order for the plaintiffs to be truly made whole, and to be returned to the status quo ante, both the tax benefits received *and* the tax consequences of their recovery must be taken into account. *Dicta* in *Hayden v. McDonald*, 742 F.2d 423, 440 (8th Cir. 1984) supports this contention, and, as the parties are in agreement, we agree that the tax consequences of plaintiffs' recovery must be considered. The parties disagree on how these tax consequences should be determined. We find Loftsgaarden's method to be reasonably accurate and much simpler than plaintiffs' formula and thus adopt Loftsgaarden's method. This method, which was also used in the "Reardon Report," which was cited in *Hayden*, takes into account the fact that, because each plaintiff will have to pay taxes on his award, the award must be calculated in an amount which each plaintiff would have to recover in order to "net out" their actual damage figure. We assume that each plaintiff is still in the fifty percent tax bracket and thus must receive twice the above amount of damages and net interest cost. Thus, in accordance with the panel's affirmance of the eight percent simple interest rate, each plaintiff is entitled to a damage award as follows: Anderson ($9,395 x 2 = $18,790); Austin ($3,833 x 2 = $7,666); Neumann ($992 x 2 = $1,984); Randall ($253 x 2 = $506).

In conclusion, the Court *en banc* affirms *Austin I* but

vacates and modifies the district court's award of damages as set forth above.

There are three remaining issues which were initially heard by a panel of this Court. These issues are: (1) Whether the district court, on remand, erred in its interpretation of *Austin I;* (2) whether attorney fees should have been awarded; and (3) whether prejudgment interest was properly calculated. For convenience, the panel's opinion is incorporated herein:

Before LAW, Chief Judge, and ROSS and McMILLIAN, Circuit Judges.

Plaintiffs urge, on cross-appeal, that the district court should have allowed them to retry their case on the "out of pocket" damages theory. At the original trial the district court noted that "out of pocket" and rescissionary damages are essentially the same. However, plaintiffs hoped to avoid the *Austin I* mandate to consider tax benefits by changing to the "out of pocket" approach. On remand, the district court refused to allow the change in theories. We find no error. The plaintiffs tendered their shares to defendants shortly before the original trial and effectively elected the remedy of rescission. More importantly, plaintiffs should not be allowed to introduce a new theory some eight years later. The case is now in its second appeal, after two trials, both of which focused on rescissionary damages. We think it too late to change theories and find no abuse of discretion by either trial judge.

Plaintiffs also argue that *Austin I* applies only to investments "expressly structured and marketed as a tax shelter." *Austin I*, 675 F.2d at 183. According to plaintiffs no factual finding has ever been made that this particular invest-

ment was expressly structured and marketed as a tax shelter. The *Austin I* court defined a tax shelter as any investment which creates tax deductions through "artificial losses." *Id.* The court en banc has endorsed that definition. *Austin II*, slip op. at 3. The evidence shows plaintiffs were able to reduce their tax liability significantly in the first few years of the investment through accelerated depreciation and other deductions.

There are several contentions relating to attorney fees. Defendants contend Neumann and Randall failed to prove a cause of action which would support any award of fees and, even if they did, the amount awarded was excessive. Plaintiffs argue that the fees awarded were insufficient and, furthermore, that fees should have been awarded to Austin and Anderson.

First, the method of damage calculation determined by the court en banc makes it clear Neumann and Randall were damaged and proved a claim for relief. We find the award of fees to Neumann and Randall falls within the range of discretion of the district court. In weighing the arguments we find no abuse of discretion.

Second, plaintiffs cannot recover fees under federal securities statute. The award to Neumann and Randall was based on Minn. Stat. § 80A.23 (2) (1984). This statute was not in effect before August 1, 1973. It is clear from the record that Anderson and Austin purchased their securities prior to that date. Under these circumstances the district court was correct in holding that Anderson and Austin were barred from recovery of attorney fees.

The issue of the method of calculating interest has been resolved by the court en banc. Plaintiffs have argued that the rate, eight percent, was too law. Defendants, on the

other hand, argue no interest can be awarded to Neumann and Randall because they suffered no actual damage and thus failed to prove a cause of action. As noted previously, the court en banc's method of damage calculation shows Neumann and Randall did suffer damage and proved a cause of action. While the district court, on remand, was not bound by the original trial judge's use of eight percent as the rate of interest, plaintiffs point to no evidence in the record which would suggest a higher rate. Although we believe the rate of interest should be based on a finding of fact from evidentiary proof, in the absence of such proof we feel the district court did not err in applying an eight percent rate as a traditional and fair rate of interest.

The panel holds that the district court, on remand, correctly interpreted *Austin I* and did not err or abuse its discretion in the award of attorney fees and pre-judgment interest. In conclusion, we remand to the district court for entry of judgment as set forth in this opinion.

HEANEY, Circuit Judge, concurring and dissenting.

I concur in the majority"s opinion except insofar as it overrules *Hayden v. McDonald*, 742 F.2d 423 (8th Cir. 1984). I continue to believe that the issue is a doubtful one and that in cases of doubt we should give great weight to a decision of a United States District Court interpreting a statute of the state in which it sits. Moreover, I think it is bad policy to reach an issue that was not presented to us by the parties and which we need not decide.

LAY, Chief Judge, dissenting, joined by BRIGHT, Circuit Judge.

I incorporate my concurrence in *Hayden v. McDonald*, 742 F.2d 423, 441-42 (8th Cir. 1984), and the reasoning set forth therein for urging that tax benefits of plaintiffs in a rescissionary damage action have no relationship to their present claim. The Department of Justice and the Securities and Exchange Commission have presented strong arguments against appellants' theory in amicae briefs.

The majority invokes the doctrine of law of the case. As Judge Learned Hand observed many years ago: "[I]it is now well settled that the 'law of the case' does not rigidly bind a court to its former decisions, but is only addressed to its good sense." *Higgins v. California Prune & Apricot* Grower, Inc., 3 F.2d 896, 898 (2d Cir. 1924). A court should never be constrained by the weight of a prior erroneous decision. The purpose of an en banc hearing is to draw on the wisdom of the full court and rectify earlier errors. Reliance on precedent is a poor substitute for analysis.

The damages provisions of the federal statute, section 12(2) of the Securities Act of 1933, 15 U.S.C. § 77*l*(2), and the Minnesota Statute, Minn. Stat. § 80A.23 (1), are quite similar:

> § 12(2): * * * recover the consideration paid for such security with interest thereon, less the amount of any income received thereon * * *.
>
> § 80A.23(1): * * * recover the consideration paid for the security together with interest at the legal rate, costs, and reasonable attorney's fees, less the amount of any income received on the securities.

The key words are "less the amount of any income received * * *." The majority concedes that the tax benefits

received by plaintiffs are not really "income." Nonetheless, the court holds the benefits must be subtracted—notwithstanding the clear language of the statute—in order to give meaning to "actual income." As Judge Arnold notes in his concurrence, the present holding as to Minnesota law cannot be rationally squared with *Hayden*.

Loftsgaarden relies heavily on *Salcer v. Envicon Equities Corp.*, 744 F.2d 935 (2d Cir. 1984), *cert. pending*. The Salcer court was concerned the plaintiff might receive a windfall and, like the majority today, applied the tax benefits in favor of the defendant, transferring any possible windfall to the wrongdoer. The Ninth Circuit has held to the contrary, using the same reasoning I urge this court to adopt. *Burgess v. Premier Corp.*, 727 F.2d 826, 837-38 (9th Cir. 1984). The *Burgess* court found that "to simply subtract the tax benefits from damages would place an unfair burden on taxpayers generally. * * * Such a result leaves the government bearing the cost of defendants' fraud." *Id.* at 838. *See also Western Federal Corp. v. Erickson*, 739 F.2d 1439, 1444 (9th Cir. 1984).

Application of tax benefits to lessen damages in a rescissionary suit actually fails to comprehend the principle behind a "tax shelter." The investor receives no money from the tax benefit; the investor simply is allowed to deduct a certain amount from his ordinary income or apply a credit toward tax owed for the particular tax year. The actual value of the benefit depends on the income bracket the investor is in, which in turn depends on other deductions that may be available to the taxpayer that year. This fact alone demonstrates how speculative any benefit in tax savings may be. More significantly, the tax benefit is not a real or actual savings—it is usually only a deferral of

tax. Ultimately, in a time of recapture when the investment is sold or otherwise disposed of, the taxpayer must return to the government tax benefits gained unless the investor suffers an actual loss. The court's conversion of the tax deferral to realized income by subtracting it from a plaintiff's damages provides a windfall to the defendant—the fraudulent party. The holding in this case violates the old principle that "[i]t is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them." Janigan v. Taylor, 344 F.2d 781, 786 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965), *quoted in Myzel v. Fields*, 386 F.2d 718, 747 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

In mitigation, the majority believes Loftsgaarden did not benefit from any of the consideration paid by plaintiffs. This is patently wrong. There was evidence at trial showing Loftsgaarden received over $100,000 profit from the investment scheme. Under the majority"s approach, Loftsgaarden gains both his own profit from the scheme and the advantage of plaintiffs' speculative tax benefits. Such a result seriously undercuts the broad protective purpose of the Securities Act of 1933. *See United States v. Naftalin*, 441 U.S. 768, 774-777 (1979).

The majority adopts the magnanimous suggestion in Loftsgaarden's brief that, in all fairness, plaintiffs' ultimate damages should be doubled in order to offset the tax consequences of recovery—assuming plaintiffs are in the fifty percent bracket. This serves to demonstrate how speculative and inaccurate the consideration of tax consequences can be in a suit involving rescissionary damages. A defendant should not have to pay damages based on the plaintiff's tax bracket in a given year. This is not a dam-

age caused by the defendant. Their theory is that to make plaintiffs whole and restore the status quo ante we must account for the tax treatment of plaintiffs' recovery. However, the relevant statutes clearly require the court to restore the consideration paid to the defrauding party, with interest, less any income actually received from the investment. And tax benefits concededly are not income received from the investment.[1] Consideration of tax benefits involves the court in the problems of recapture and net gains or losses. In turn, the court finds it must consider each plaintiff's income and deductions in the year of recovery to net out "actual damages" based on applicable tax rates. Rather than making up an artificial theory of damage by doubling the net gain, it is much simpler and more accurate to provide the plaintiff with restitution of his investment. The statutes provide a clear and simple formula. For example, Anderson invested $35,000 for a period of seven years. Loftsgaarden paid Anderson no interest or dividends and returned no principal. Anderson should recover $35,000 with interest for those seven years. Anderson will have to pay tax on the interest at ordinary income rates. In addition, he may be required to recapture past benefits. The tax transaction is between Anderson and the government and should not affect Loftsgaarden's liability. By this method a plaintiff recovers exactly what he lost: the principal, and interest he would have earned had that principal been invested in a legitimate security.[2]

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[1]If depreciation deductions were actually "income," then every taxpayer who takes such a deduction would have to include it as gross income on the next year's tax return, rather than applying it to the property's basis.

[2]It is reasonable to assume that if plaintiffs had not invested in Loftsgaarden's fraudulent scheme, they would have invested in another legitimate project which would have returned similar tax benefits as well as principal and interest over the life of the investment. The majority's approach will not make plaintiffs truely whole because the tax benefits are subtracted from the return of principal and interest.

This procedure is far more simple than requiring trial courts to undertake complicated and speculative evidentiary hearings on the mechanics of tax deferral plans and plaintiffs' tax status in given years of investment.

Today's holding provides the wrongdoer a surety by which to avoid liability, allowing the fraudulent party to use the United States Treasury for security in any fraudulent transaction. To the extent a defendant can, by his wrongful act, create a tax loss for the innocent victim, the defendant will be allowed to escape liability, shifting the burden of the loss onto the government. I do not believe section 12(2) or section 80A.23 (1) was designed to accomplish this result. Accordingly, I dissent.

A true copy.

Attest:

CLERK, U. S. COURT OF APPEALS, EIGHTH CIRCUIT.

APPENDIX B

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA
FOURTH DIVISION

Dr. Roger E. Austin, Dr. Tom W. Anderson, Dr. Myrel A. Neumann and Dr. William C. Randall,

Plaintiffs,

vs.

B. J. Loftsgaarden; Alotel Incorporated, a Minnesota corporation; M.S. Noah; John W. Burg; Lyman H. Coult; Robert R. Dunlap; and Property Development & Research Company, a Minnesota corporation,

Defendants.

Civil 4-76-82

AMENDED JUDGMENT

Upon defendants' motion for amended findings of fact and an amended judgment, and pursuant to Fed. R. Civ.P. 52 and 59, this court finds that the amount of prejudgment interest awarded to plaintiffs in its order of February 22, 1984 be amended as follows to reflect simple interest at 8 per cent:

Plaintiff Anderson	
Consideration paid June 2, 1973:	$35,000
Plus interest at 8% to February 22, 1984:	$64,787
Minus tax benefits:	$29,615
Total damages:	$35,172

Plaintiff Austin	
Consideration paid June 6, 1973:	$35,000
Plus interest at 8% to February 22, 1984:	$64,610
Minus tax benefits:	$33,333
Total damages:	$31,277
Plaintiff Neumann	
Consideration paid August 21, 1973:	$35,000
Plus consideration paid October 19, 1973:	$17,500
Plus interest at 8% to February 22, 1984.	$96,385
Minus tax benefits:	$57,014
Total damages:	$39,371
Plaintiff Randall	
Consideration paid November 13, 1973:	$35,000
Plus interest at 8% to February 22, 1984:	$63,770
Plus consideration paid 1975:	$2,512
Plus interest at 8% to February 22, 1984:	$4,203
Sub total:	$67,973
Minus tax benefits:	$36,404
Total damages:	$31,569

This order amends only the interest calculations of the February 22 order, and the rest of that order—including awards of attorneys' fees and costs—stands intact.

IT IS SO ORDERED.

Dated: March 26, 1984.

/s/ Miles W. Lord
Chief Judge

APPENDIX C

(Title of Cause.)

Civil 4-76-82

ORDER

The plaintiffs in this case are four investors in a limited partnership who claim they were defrauded by defendants because of misrepresentations, half-truths and omissions in the Offering Memorandum used to attract them to a project to build and operate a Ramada Inn in Rochester, Minnesota. In a 1980 trial before Judge Larson of this court, plaintiffs prevailed on various claims against defendant B. J. Loftsgaarden and three of his closely-held corporations (hereinafter Loftsgaarden).[1] A jury found Loftsgaarden liable on claims under §10b(5) of the Securities Exchange Act of 1934, Rule 10b-5, Minn. Stat. §80A.01 *et seq.*, 80A.123, and common law fraud. The jury also found, in an advisory opinion adopted by Judge Larson, that Loftsgaarden had violated § 12(2) of the Securities Act of 1933.

Loftsgaarden appealed. The Eighth Circuit Court of Appeals affirmed on the issue of liability, but remanded on the issue of damages. *Austin v. Loftsgaarden*, 675 F.2d 168 (8th Cir. 1982). Specifically, the appeals court held that the amount of tax benefits received by plaintiffs as a result of this investment must be deducted from the damages assessed against Loftsgaarden. *Id.* at 183-84.

This court held a bench trial on the tax benefits question on December 2, 1983, after which time the parties submitted additional briefs and affidavits. In addition to tax

[1]Defendants Noah and Coult were found not liable.

benefits, two other issues are now before this court: whether plaintiffs are entitled to prejudgment interest and whether plaintiffs are eligible for an award of attorneys' fees against Loftsgaarden.

AMOUNT OF TAX BENEFITS RECEIVED BY PLAINTIFFS.

At the 1980 trial, Judge Larson refused to admit Loftsgaarden's evidence on the amount of tax write-offs these high-income plaintiffs enjoyed as a result of their Ramada investment losses, stating that the court was "not going to get into a lot of complicated tax testimony." (T. 23) Judge Larson later characterized Loftsgaarden's tax benefit argument as "sophistic malarky." Memorandum Order No. 4-76-82 (D. Minn. Aug. 15, 1980).

The appeals court saw otherwise:

> [W]e hold that the court committed reversible error in refusing to allow proof of any economic benefits received by plaintiffs on account of the investment and in failing to instruct the jury that the damage award must be reduced by any value shown to have been received by plaintiffs.
>
> ***
>
> In conclusion, we hold that in a private securities fraud action involving an investment structured and marketed as a tax shelter, where a rescissory measure of damages is applied, evidence of any benefit derived by the plaintiff/investor must be permitted.

Austin, 675 F.2d at 181 and 183-84.

At the December hearing before this court, three of the four plaintiffs accepted Loftsgaarden's calculations on the

amount of tax benefits they had received. Therefore, this court also adopts Loftsgaarden's accounting on these three plaintiffs as follows:

Anderson tax benefits:	$29,615.00
Austin tax benefits:	$33,333.00
Neumann tax benefit:	$57,014.00

The fourth plaintiff, Randall, refused to concur with the computations of Loftsgaarden's accountant. Indeed, plaintiff Randall continued to steadfastly maintain that he received no tax benefits at all in an argument that appears to be an attempt to reopen the issue conclusively decided by the Eighth Circuit. *See* Plaintiff Randall's Trial Brief at 5-6. This court refuses to entertain such an argument at this juncture in the proceedings.

Plaintiff Randall also asserted that he is entitled to rescind his entire investment, thereby recovering his money and amending his IRS returns to disgorge any tax benefits. Under this approach, plaintiff Randall again declares that there are no tax benefits to charge against his damage award. However, this court finds Randall's argument to be an untimely attempt to change the damage theory in this case. Both Judge Larson and the Eighth Circuit held that plaintiffs were entitled to a rescissory measure of damages, not rescission itself. By attempting to change the theory of damages at this late date, plaintiff Randall is struggling to further protract and complicate a proceedings that has already dragged on far too long. That will not be tolerated by this court.

Finally, plaintiff Randall submitted an accountant's calculations under this court's and the Eighth Circuit's theory of damages that is at odds with that of Loftsgaarden's ac-

countant. Randall claims his tax benefits totaled $26,-085.59; Loftsgaarden claims the figure is $36,404. At the December trial, it was established by the testimony of the accountants that the major factor producing different numbers was that Randall's accountant used an estimated tax rate of 54 percent, while Loftsgaarden's used the actual rates reflected in the returns. Obviously, this court finds that it is more appropriate to employ actual rates and therefore accepts Loftsgaarden's accounting. Thus, it is the finding of this court that plaintiff Randall's tax benefits from this investment amounted to $36,404.

PREJUDGMENT INTEREST

All plaintiffs assert that they are entitled to prejudgment interest on their damages awards under both § 12(2) of the Securities Act of 1933, 15 U.S.C. 1(2), and Minn. Stat. §80A.23, subd. 2. These statutes read as follows:

> Any person who ... offers or sells a security ... [in violation of this paragraph] ... shall be liable to the person purchasing such security from him, who may sue ... in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security ...

15 U.S.C. § 77*l*(2).

> Any ptrson who violates Section 80A.01 ... shall be liable to any person damaged thereby ... to whom he sold such security .... Damages in an action pursuant to this subdivision shall include the actual damages sustained plus interest from the date of payment ..., costs and reasonable attorneys' fees.

Minn. Stat. 80A.23, subd. 2.

In his post-trial memorandum, Judge Larson awarded prejudgment interest at the traditional rate of 8 percent to all plaintiffs under the federal statute cited above. Judge Larson found that plaintiffs Randall and Neumann also would be entitled to interest under the Minnesota Statute, but that plaintiffs Austin and Anderson were not covered by the state law because they invested prior to the act's implementation date. Since the Eighth Circuit did not disturb Judge Larson's ruling that Loftsgaarden was liable to all plaintiffs under the federal statute, this court reiterates his order that all plaintiffs be awarded prejudgment interest at 8 percent under §12(2) of the Securities Act.

CALCULATION OF DAMAGES

Based on the foregoing discussion, the starting point for assessing damages will be the amount each plaintiff paid Loftsgaarden for his investment (in other words, the plaintiff's consideration). To this, the court will add 8 percent interest from the date the consideration was paid to the date of this order. Finally, the amount of each plaintiff's tax benefits will be subtracted from the sum of his consideration and interest. This computation produces the following results:

Anderson	
Consideration paid June 2, 1973:	$35,000.00
Plus interest at 8% to February 22, 1984:	$79,905.00
Minus tax benefits:	$29,615.00
Total Damages:	$50,290.00

Austin	
Consideration paid June 26, 1973:	$35,000.00
Plus interest at 8% to February 22, 1984:	$79.501.00
Minus tax benefits:	$33,333.00
Total Damages:	$46,168.00
Neumann	
Consideration paid August 21, 1973:	$35,000.00
Plus consideration paid October 19, 1973:	$17,500.00
Plus interest at 8% to February 22, 1984.	$117,532.00
Minus tax benefits:	$57,014.00
Total Damages:	$60,518.00
Randall	
Consideration paid November 13, 1973:	$35,000.00
Plus interest at 8% to February 22, 1984:	$77,189.00
Plus consideration paid 1975:	$2,512.00[2]

[2]This additional item of consideration stems from $7,500 in loans from Randall to Loftsgaarden. The full amount of these loans cannot be included in Randall's consideration since the jury found, and Judge Larson and the Eighth Circuit concurred, that there was no liability for the loans because there was no reliance on misrepresentation at the time the loans were made. However, since Loftsgaarden included the $7,500 in Randall's basis for his calculation of tax benefits (which inures to Loftsgaarden's benefit), Randall should be able to claim that amount as income invested. According to Loftsgaarden's accountant, inclusion of the $7,500 in Randall's basis generated tax benefits of $2,512. (Randall's accountant states that inclusion of the loans resulted in tax benefits of $2,025. Since no clear indication is given as to how this figure was arrived at, the court accepts the calculations of Loftsgaarden's accountant. Surprisingly, Randall's calculations is more favorable to the defendant than the defendant's own figure.)

Plus interest at 8% to February 22, 1984:	$4,650.00
Subtotal:	$81,839.00
Minus tax benefits:	$36,404.00
Total Damages:	$45,435.00

Defendant Loftsgaarden disputes this straightforward method of computation. His approach would be to subtract the tax benefits from consideration paid before adding on interest, a course that drastically reduces or completely obliterates each plaintiffs award. However, the clear language of § 12(2) presents the order in which to consider these items. "consideration paid ... with interest thereon, less the amount of any income received ...." These words present an express directive to this court, and defendant cites no cases directly on point which hold to the contrary.

ATTORNEYS' FEES

All plaintiffs have petitioned this court for attorneys' fees under Minn. Stat. §80A.23, subd. 2, which specifically provides for such an award. (None of the federal statutes involved in this case authorizes attorneys' fees.)

As noted above, however, §80A.23 does not apply to all plaintiffs. Austin and Anderson purchased their interests in the limited partnership before August 1, 1973, the statute's effective date. Judge Larson found that these dates of sale were the crucial determinants in deciding whether these two plaintiffs were covered by the new statute, since the facts which formed the basis of their claims was the fraud which took place when they purchased their interests. Austin and Anderson point to some broad language in the Eighth Circuit opinion to support their contention that the new statute embraces their claims.

However, there is no indication anywhere in the opinion that the Eighth Circuit was doing anything more than affirming Judge Larson's findings on liability. Therefore, in accordance with Judge Larson's opinion, this court finds that only plaintiffs Randall and Neumann can recover their attorneys' fees.

This ruling is somewhat mitigated by the fact that Austin and Anderson shared attorneys with Neumann. As Judge Larson found, most of the work performed by these plaintiffs' attorneys would have been done even if Neumann had been the only client.

Judge Larson granted attorneys' fees of $10,000 to Randall and $15,000 to Neumann. In addition, Judge Larson awarded costs of $1,308.62 to Randall and $2,-210.53 to Neumann, Austin and Anderson. These amounts have never been paid. This court now orders that they be paid pursuant to this memorandum.

The fees considered by Judge Larson were those incurred through the trial of this action. Attorneys' fees covering the appellate proceedings have already been paid. Remaining for consideration, then, is the post-appellate phase of this suit, that is, time spent on the issues of damages and prejudgment interest.

For this segment, plaintiffs Neumann, Austin and Anderson request attorneys' fees of $16,174.17 based upon hourly rates of $60 to $135. Plaintiffs' attorneys faced a complex case and a zealous defense. As already noted, although only Neumann is entitled to fees, much of the work was done for these three plaintiffs as a group by their common attorneys. This court finds that a reasonable fee for Neumann would be $14,000 and also awards these three plaintiffs costs of $3,111.30. *See Zoll v. Eastern*

Allamakee Community School District, 588 F.2d 246 (8th Cir. 1978); *State v. Paulson,* 188 N.W.2d 424 (Minn. 1971).

Plaintiff Randall requests attorneys' fees of $14,825 based upon rates of $50 to $100. However, this request is based on a recalculation by Randall's attorney who went back through his time records to update his hourly fee to the rate he currently charges, not the rate he charged at the time the work was performed. This court finds that a reasonable fee would be $10,000 plus costs of $1,647.87.

SUMMARY

Based upon the foregoing discussion, IT IS HEREBY ORDERED THAT:

1. Damages awards be granted in the following amounts:

Anderson:	**$50,290.00**
Austin:	$46,168.00
Neumann:	$60,518.00
Randall.	$45,435.00

2. Attorneys' fees be granted as follows;

Neumann:	$29,000.00
Randall:	$20,000.00

3. Costs be granted as follows:

Anderson, Austin and Neumann:	$5,321.83
Randall:	$2,955.49

IT IS SO ORDERED.

Dated: February 22, 1984.

/s/ Miles W. Lord
Chief Judge

APPENDIX D

No. 80-1771
No. 80-1874

Dr. Roger E. Austin, Dr. Thomas W. Anderson, Dr. Myrel A. Neumann and Dr. William C. Randall,
Plaintiffs, Appellees and Cross Appellants,

v.

B. J. Loftsgaarden; Alotel Incorporated, a Minnesota Corporation; M. S. Noah; Lyman H. Coult; Property Development & Research Company, a Minnesota Corporation; and 2361 Building Corporation, a Minnesota Corporation,
Defendants, Appellants and Cross Appellees.

Appeal from the United States District Court for the District of Minnesota

Submitted: June 17, 1981
Filed: April 7, 1982

Before McMILLIAN and ARNOLD, Circuit Judges, and HANSON, Senior District Judge

HANSON, Senior District Judge.

Plaintiffs-appellees are four of twenty-two limited partners who invested in a development to build and operate a Ramada Inn Motel in Rochester, Minnesota. In the district court they prevailed on various claims that they were defrauded by defendants-appellants B. J. Loftsgaarden and

three of his closely-held corporations because of misrepresentations, half-truths, and omissions that were found to exist in the Offering Memorandum used to attract plaintiffs to the project.[1] A jury found Loftsgaarden and the corporate defendants (hereinafter Loftsgaarden) liable upon claims under § 10 (b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j (b); Rule 10b-5, 17 C.F.R. § 240.10b-5; the antifraud provisions of the Minnesota Securities Act, Minn. Stat. §§ 80A.01, 80A.23; and common law fraud.[2] The jury also rendered an advisory ver-

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[1]Defendants Noah and Coult, officers and directors of the corporate general partner, Alotel, Inc., were found not liable.

[2]§10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b), provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any national securities exchange—
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5 implementing §10(b), 17 C.F.R. §240.10b-5, provides:

> Employment of manipulative and deceptive devices.
>
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Minn. Stat. §80A.01 provides:

> It is unlawful for any person, in connection with the offer, sale or purchase of any security, directly or indirectly:
>
> (a) to employ any device, scheme or artifice to defraud;
>
> (b) to make any untrue statement of a material fact or to omit to state material facts necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading; or
>
> (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

dict—in which the district court concurred—that defendoants were liable for violating § 12(2) of the Securities Act oof 1933. 15 U.S.C. § 77*l*(2).[2] The district court applied a rescissory remedy, which resulted in an award to plaintiffs in the amount of the consideration that each had paid for his limited partnership unit or units, prejudgment interest from the date of purchase, and attorneys' fees for plaintiffs Randall and Neumann for a total judgment of $273,720. Defendants raise a number of issues on appeal mainly relating to the sufficiency of evidence on the essential elements of these claims and the measure of damages. Plaintiffs cross-appeal from the district court's denial of certain portions of their requested attorneys' fees. We affirm as to the finding of liability, but remand for further consideration on the issue of damages.

I.

B. J .Loftsgaarden is an attorney and the president and sole shareholder of corporate defendants Alotel, Inc., Property Development and Research Company (PDRC),

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[2] § 12(2) of the Securities Act of 1933, 15 U.S.C. § 77*l*(2) provides in pertinent part:

> Any person who —
>
> (2) offers or sells a security . . ., by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

and 2361 Building Corporation. Through these corporations, Loftsgaarden intended to build and operate a Ramada Inn in Rochester, Minnesota.[4] To help finance the $3.5 million project, he organized a limited partnership, Alotel Associates, through which he expected to raise $1 million by selling 40 limited partnership units to not more than 20 investors for $25,000 per unit. The remainder of the money was to be obtained through a $2.31 million mortgage loan from Larwin Realty and Mortgage Trust[5] and a $240,000 furniture and fixtures loan from the First National Bank of Rochester. Loftsgaarden and Alotel, Inc., were to serve as the project's general partners.

In December 1971, Loftsgaarden prepared an offering memorandum through which he hoped to interest investors in the limited partnership units. The memorandum indicated that the partnership would "operate as a 'tax shelter' ", leading to "significantly greater returns for persons in relatively high income tax brackets." Accordingly, the memorandum outlined "Investor Suitability Standards" requiring that each investor have a net worth in excess of $200,000 excluding home and automobiles or that some portion of the investor's income was subject to federal and state income taxes at a rate of fifty percent or more. Paul Crawford, an investment advisor whom Loftsgaarden knew was not licensed to act as such, agreed to help Loftsgaarden find suitable high income investors.

The attraction of such an investment to high tax bracket

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[4]PDRC was the entity through which the real estate would be obtained and 2361 was to serve as the project's general contractor.

[5]The $2.31 million loan would initially be made by First National Bank of St. Paul, which would supply interim construction financing to the partnership. Once motel construction was completed, Larwin would buy the loan from the St. Paul bank pursuant to a "take-out" commitment and put in its place a first mortgage.

individuals lies in the tax treatment of the partnership's income and losses. Because the partnership is not taxed as an entity, it serves as a conduit to the partners for all its taxable income and losses. I.R.C. §§ 701, 702. Each partner is permitted to take his or her share of the partnership's deductible losses "to the extent of the adjusted basis of such partner's interest in the partnership...." I.R.C. § 704 (d). But in a real estate investment such as the one contemplated by Loftsgaarden, the limited partner's basis is not restricted to the amount of his actual investment (the amount "at risk"); rather, it may be increased by the partner's proportional share of any nonrecourse loans made by the partnership. *See* I.R.C. § 465 (c) (3) (D). Against such an increased basis, a limited partner is able to receive from the partnership deductible losses far in excess of the amount he or she has at risk in the investment. By using accelerated methods of depreciation, prepaying interest on loans, renting instead of purchasing land, and other methods, the partnership is able artificially to generate large amounts of deductible losses and expenses in the early years of the venture which are passed on to the partners to use in offsetting other income on their individual tax returns.[6] The result is that a

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[6]One commentator offers the following example:

> A hypothetical real estate partnership might show a $50,000 loss in one year. Assume that this loss was obtained by taking the difference between $60,000 of deductible depreciation and $10,000 of gross rents in excess of operating expenses and interest. If mortgage amortization, a nondeductible expense, were $2,000, then the partnership would have a positive cash flow of $8,000. If under the partnership agreement, one limited partner were entitled to 50% of the partnership losses and 37.5% of the cash flow, that partner would receive $3,000 in cash, but his tax return would reflect only his share of the partnership's net loss, or $25,000.

Note, *Real Eestate Limited Partnerships and Allocational Efficiency: The Incentive to Sue for Securities Fraud*, 63 Va.L.Rev. 669, 673 n.22 (1977). *See also* T. Dahlk, *Real Estate Partnerships and the Securities Laws: A Primer*, 12 Creighton L.Rev. 781, 783 (1979); R. Hrusoff, *Securities Aspects of Real Estate Partnerships*, 11 Ca.W.L.Rev. 425, 458 (1975).

limited partner can often recoup his money in the year of his investment through tax savings. Generally the tax shelter serves only to defer taxation until the investment is liquidated and each partner receives his or her proportional share of the proceeds of the sale. Any gain realized will be taxed partly at capital gains rates (assuming the greater than one year holding period has been satisfied) and partly at ordinary income rates (to the extent that the accelerated depreciation taken exceeds the amount that would have been taken if a straight-line method were used). I.R.C. §§ 1231, 1250.

Under the terms of Loftsgaarden's offering memorandum, Alotel Associates planned to employ some of the above-described methods to provide immediate tax savings to the limited partners. The $2.31 million loan from Larwin would be a nonrecourse loan, thus serving to increase each limited partner's investment basis. In addition, rapid depreciation methods would be used to generate large deductible losses in the early years of the investment. Despite these features, only one person was willing to make the $50,000 minimum investment. This forced Loftsgaarden to terminate the offering and revise the project to further enhance the tax benefits and reduce the minimum price per investor. Instead of purchasing land as originally contemplated, the partnership would rent land thereby incurring another tax deductible expense.[7] Since capital

[7]The land rental would be effected through a sale-leaseback arrangement whereby the partnership would acquire the land, sell it to a third party, and then lease it back from the third party purchaser. In reality, the transaction worked as follows: Part of the land was purchased by the partnership and then sold to Loftsgaarden's corporation, PDRC. In turn PDRC purchased the remainder of the land outright, then sold the entire parcel to a third party, which leased the land back to PDRC. Then PDRC subleased the land back to the partnership.

was no longer required to purchase land, the amount of money Loftsgaarden needed to raise through the sale of limited partnership units was reduced from $1 million to $700,000. This also reduced the minimum investment per limited partner from $50,000 to $35,000 and the total number of units from 40 to 20.

In May 1973, Loftsgaarden revised the offering memorandum to reflect these changes. An accounting forecast included in the memorandum stated that the partnership would suffer losses resulting in income tax savings during its first three years; thereafter the business would begin to show a profit. Again Crawford aided Loftsgaarden in finding suitable high income investors. This time the offering proved successful. In the summer and fall of 1973, plaintiffs—Drs. Roger Austin, Thomas Anderson, Myrel Neumann, and William Randall—were among those who purchased units.[8] The jury found that plaintiffs bought their units in reliance on the representations made in Loftsgaarden's offering memorandum and upon the advice of either Crawford[9] or their own financial advisors who in turn relied on the memorandum.

Among other matters, the offering memorandum represented that Loftsgaarden could obtain interim construction financing for the motel at an interest rate of nine and one-half percent; that the construction loan interest would amount to $130,000; that the land lease would run for forty years with renewal and purchase options; that construction of the motel would begin in May 1973 and be completed seven months later in December 1973; that the

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[8]Plaintiffs each purchased one $35,000 unit except for Dr. Neumann who bought one and a half units for a total investment of $52,000.

[9]Loftsgaarden admits that Crawford made no representations "other than those in the Offering Memorandum." **Brief for appellants at 16.**

developer and the construction company (i.e., Loftsgaarden and 2361) would receive $103,000 for "overhead and profit"; that the $240,000 furniture and fixtures loan from the Rochester bank would be at an interest rate of eight percent; and that Alotel Associates had procured a firm commitment for long term financing[10] from Larwin. Findings of Fact, Conclusions of Law, and Order for Judgment, Designated Record (D.R.) 445-59.[11]

These representations were found to be false. In fact, Loftsgaarden had not obtained either the interim construction loan or the furniture and fixtures loan at the stated fixed interest rates, but rather at interest rates that floated ing rate. The land lease was for fifteen years with a fifteen-year renewal option instead of forty years with renewal and purchase options. Loftsgaarden knowingly underestimated the construction time by five months, thus the memorandum's estimate that construction loan interest would amount to $130,000 was too low because it was based on a lower interest rate and a shorter construction time than actually expected. It was also not true that he had a firm commitment from Larwin for tthe partnership's permanent financing. The loan was contingent upon Larwin receiving adequate assurance that it was not usurious under Minnesota law.[12] Overall, the budgets and fore-

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[10]At a nine and one-half percent interest rate.

[11]These findings and conclusions relate to the district court's ruling on plaintiffs' §12(2) claim and are consistent with the special verdict returned by the jury upon the §10(b), Rule 10b-5, Ch. 80A. and common law fraud claims. D.R. 266-74.

[12]At the time the offering memorandum was circulated, Minnesota law limited interest rates on loans to noncorporations to eight percent. Larwin finally agreed to make the loan through a corporate nominee, PDRC, which borrowed the money at nine and one-half percent from Larwin and then advanced it to the partnership at the legal rate of eight percent. PDRC recovered its loss on the transaction by adjusting the land rent it charged to the partnership. *Supra* note 7.

casts in the offering memorandum were found to be based on unreasonable and misleading assumptions.

Additionally, it was found that Loftsgaarden had omitted any explanation of the role his closely-held corporation would assume in the development. He did not reveal that PDRC expected to earn a profit on the various land transactions required to set up the sale-leaseback arrangement, that PDRC would receive a commitment fee for having obtained financing for the partnership, and that he owned a thirty percent interest in ARC-TEC—the architectural firm with which he contracted to design the motel. Overall, it was clear that Loftsgaarden and the corporate defendants expected compensation considerably greater than the $103,000 stated in the offering memorandum, their expectation being more on the order of $240,000.

Alotel Associates encountered financial difficulties from the project's inception. Construction costs exceeded those budgeted, largely because of ever-increasing interests rates.[15] When the motel finally opened in June 1974, operating expenses exceeded those that were forecast and occupancy rates fell short of expected levels. Exacerbating matters was Larwin's refusal to "take out" (*supra* note 5) the interim construction loan upon completion of construction because it had not received adequate assurances that its loan to the partnership was legal under the Minnesota usury law. Loftsgaarden was not able to placate Larwin and get the permanent financing in place until De-

[15]The district court's findings indicate that the prime rate charged by the construction lender, First National Bank of St. Paul, rose from six percent in February 1973 to ten percent in February 1974. As has already been noted, the partnership was obliged to pay interest on this $2.31 million loan at a floating rate of four percent over the bank's prime lending rate.

cember 1974, resulting in an additional six months of high interest charges to the partnership. Loftsgaarden sold five additional units in Associates in October 1974 to raise $175,000 for repayment of debts and additional operating capital. In February 1975 Loftsgaarden asked the limited partners to make $125,000 in loans to keep Associates afloat. The limited partners hired an accountant, John Essene, to investigate the partnership's financial condition. Essene reported in March that in fact $200,000 would probably be required to continue business operations. Plaintiffs and other limited partners did make loans to Associates at this point,[14] but they also hired an attorney to make further investigation of the partnership's financial affairs. The district court found that by August or September 1975, plaintiffs knew or should have known of defendants' fraud. In September, Loftsgaarden agreed to resign as general partner; thereafter plaintiffs made additional loans to Associates, but the business continued to flounder. Associates ultimately defaulted on its loans and land rent payments and foreclosure by creditors ensued.

Plaintiffs filed their complaint on February 24, 1976. On June 25, 1980, after a seven-day trial, the jury found that Loftsgaarden knowingly had made material misrepresentations and omissions in the offering memorandum upon which plaintiffs relied and which caused plaintiffs' damages, thus satisfying all the elements of the § 10 (b), Rule 10b-5, Ch. 80A, and common law fraud claims.[15] The district court also accepted the jury's advisory verdict that Loftsgaarden was liable under § 12(2) because

[14]The jury found that neither these nor any subsequent advances were induced by any misrepresentations by Loftsgaarden and plaintiffs were not entitled to recover any of the amounts advanced.

[15]The parties agree that the elements of these various claims are identical.

he knowingly made material misrepresentations or omissions of which plaintiffs were unaware, and because there was some causal connection between Loftsgaarden's wrongful conduct and plaintiffs' purchases.[16] *See Alton Box Board Co. v. Goldman, Sachs & Co.*, 560 F.2d 916 (8th Cir. 1977).

II.

Loftsgaarden complains that there is insufficient evidence of materiality, reliance or causation to sustain the jury's verdict upon plaintiffs' § 10 (b), Rule 10b-5, Ch. 80A. and common law fraud claims. It is also claimed that the district court's findings of materiality and causation in support of its conclusion that liability existed under §12 (2) are clearly erroneous.

A.

A statement or omitted fact is considered material if it is substantially likely that a reasonable investor would consider the matter important in making an investment decision. *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).[17] Whether or not the misrepresented or omitted fact is important turns on whether a reasonable investor would regard it as significantly altering the total mix of information made available. *Id.*

Leaving aside the relatively few misrepresented and omitted matters which Loftsgaarden claims are unsupported by the evidence, we focus upon what we regard as

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[16]Reliance is not an element of an action under §12(2). *Alton Box Board Co. v. Goldman, Sachs & Co* 560 F.2d 916, 924 (8th Cir. 1977).

[17]*TSC Industries* arose under §14(a) of the Securities Exchange Act of 1934, but the test for materiality is the same under all of the securities statutes. *See Alton Box Board Co. v. Goldman, Sachs & Co., supra* at 919-20.

his primary challenge to the materiality finding Loftsgaarden in effect admits that the following facts were either misrepresented in or omitted from the offering memorandum, but he argues that these facts should be deemed immaterial: Loftsgaarden held a 30% interest in ARC-TEC; the partnership was to pay a $25,000 brokerage fee in conjunction with the sale of land; the project was a revision of a prior failed offering by Loftsgaarden; Crawford was an unlicensed seller; the interest rate on the interim construction loan floated at four percent over the prime rate; the land lease was for a shorter term than represented; the furniture and fixtures loan was to be secured by a chattel mortgage; the permanent financing from Larwin was contingent upon assurances that it would not be usurious; the corporate general partner was an unfunded shell corporation; Loftsgaarden stood to gain over twice the profits stated; and the offering, while not required to be registered with the state, would have failed to qualify had registration been sought.

The jury applied the proper standard of materiality and found that full disclosure of the above matters would be regarded as important by a reasonable investor. The Supreme Court has recognized that the trier of fact is uniquely competent to make the materiality determination, requiring as it does "delicate assessments of inferences a [reasonable investor] would draw from a given set of facts . . . ." *Id.* at 450. We cannot fault the jury's assessments in this case and we uphold the materiality finding.

B.

Ordinarily, reliance requires proof that the misrepresentations actually induced plaintiffs to act differently than

they otherwise would have in making their investment decisions. *St. Louis U. Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 562 F.2d 1040, 1048 (8th Cir. 1977), *cert. denied*, 435 U.S. 925 (1978). But in cases involving primarily a failure to disclose, reliance will be presumed upon a showing that the withheld information was material. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54 (1972). Because there were both misrepresentations and omissions in the offering memorandum, Loftsgaarden requested and the jury given a dual instruction which stated that plaintiffs had the burden of proving they relied on the misrepresentations, but that as to the omissions, reliance was presumed upon a showing of the materiality of the omitted facts.[18]

Loftsgaarden contends that there is no evidence to support a finding of reliance in this case. On the contrary, the record indicates that the only information received by plaintiffs came from the offering memorandum. Austin testified that he went over the offering memorandum with Crawford, devoting particular attention to the forecast

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[18]The court instructed:

> In this case, the plaintiffs allege that the offering memorandum which was supplied to them by defendant Loftsgaarden contained representations which were false and misleading. They also alleged that defendant Loftsgaarden made oral representations to them at the time that they purchased their units in Alotel Associates, and at the time that further contributions to the partnership were solicited, which were false and misleading. As stated above, before the plaintiffs can prevail on these claims, they must first prove that such false and misleading representations were made. In addition, the plaintiffs must prove that they in fact relied upon these representations.
>
> The plaintiffs also claim that the offering memorandum was false and misleading in that it failed to disclose material facts. Where the claims asserted under Section 10(b) or Rule 10b-5 relate to nondisclosure as opposed to misrepresentations, then, if the nondisclosed facts are material, there is a presumption that the plaintiffs relied upon that nondisclosure. In that case, the plaintiffs need not prove that they would have acted differently had the facts been disclosed.

T. 795-96.

of cash flow, and that the memorandum "was the principal reason, I would say, that I invested in it." T. 557. Likewise, Anderson testified that he read and made notes on the offering memorandum and that it was "the extent of the information I did have at the time I invested." (T. 591. Randall relied on the advice of his accountant, John Essene, who testified, "All I had to work with was the offering circular. . . . It was really the only source of information that was available." T. 494. Neumann relied on the advice of his accountant and business partner, Delroy Blaske, who reviewed and analyzed the offering memorandum, particularly focusing on the forecasts. Blaske testified the offering memorandum was "all we had to go on." T. 568.[19]

Loftsgaarden argues that there is no evidence plaintiffs actually were misled by any of the specific aspects of the offering memorandum that were found to have been misrepresented. But misrepresentations so permeated this document that the trial court found their cumulative effect was to render the forecasts and projections unreasonable and misleading.[20] Accordingly, reliance could be found

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[19]Loftsgaarden argues that no "derivative reliance" theory (i.e., plaintiffs relied on experts who in turn relied on the offering memorandum) may be advanced because such a theory was neither pled nor raised at trial. *See Kiernan v. Homeland, Inc.*, 611 F.2d 785, 789-90 (9th Cir. 1980). We reject this argument. The so-called derivative reliance theory was disallowed in *Keirnan* because plaintiff raised it for the first time on appeal, effectively denying defendants any opportunity for rebuttal. In addition, plaintiff failed to introduce any evidence that the third parties upon whom he purportedly relied did themselves rely on any misrepresentations. In the instant case, the third parties upon whom Neuman and Randall relied. Blaske and Essene, gave direct testimony and were subject to cross-examination on the reliance issue.

[20]*Cf. Nye v. Blyth Eastman Dillon & Co.*, 588 F.2d 1189, 1197 n.14 (8th Cir. 1978) ("The appellants attempt to separate out each misrepresentation and show that each was insufficient to mislead the appellees. Such a position has little merit. Considered in the aggregate, we agree with the trial court that the misrepresentations did induce reliance on the part of the appellees.").

from evidence that plaintiffs' only source of information in making their investment decisions was the offering memorandum.

It is next argued that the trial court erred in failing to instruct that the presumption of reliance upon material omitted facts is rebuttable. This point would be more troublesome were we confronted with a situation where the only reliance instruction given was a presumption instruction. In such a case, we think it is necessary that defendant be allowed to rebut the presumption of reliance and that the jury be instructed on the rebuttable nature of this presumption. *See Sharp v. Coopers & Lybrand,* 649 F.2d 175, 189 (3d Cir. 1981); *cert. denied,* 50 U.S.L.W. 3668 (U.S. February 23, 1982) (No. 81-433); *Shores v. Sklar,* 647 F.2d 462, 476 (5th Cir. 1981), *petition for cert. filed,* 50 U.S.L.W. 3377 (U.S. November 2, 1981) (No. 81-839); *St. Louis U. Trust Co., supra* at 1049. But we hold that Loftsgaarden suffered no prejudice in the instant case by the omission of the rebuttability instruction because, independent of any presumption of reliance that may have been made, the jury found that plaintiffs affirmatively proved reliance.[21]

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[21]It is not apparent from the findings on the §10(b) and Rule 10b-5 claims whether the jury found affirmative proof of reliance upon misrepresentations or presumed reliance based on material omissions or both. The issue, however, is clarified by the jury's alternative finding of liability based upon common law fraud. In this regard, the trial court instructed that plaintiffs had the burden of affirmatively proving reliance in order to recover.

Overall, the instructions and special verdict questions fully and correctly presented the reliance issue to the jury. We are, however, inclined to agree with the Third Circuit that a dual instruciton on reliance is not the appropriate solution when confronted with a securities fraud case where both misrepresentations and omissions are present. We endorse that circuit's conclusion that "the proper approach to the problem of reliance is to analyze the plaintiff's allegations, in light of the likely proof at trial, and determine the most reasonable placement of the burden of proof of reliance." *Sharp v. Coopers & Lybrand,* 649 F.2d 175, 188 (3d Cir. 1981). Such an approach is consistent with this circuit's view that the presumption of reliance is limited to cases involving primarily omissions. *Vervaecke v. Chiles, Heider & Co.,* 578 F.2d 713, 716-17 (8th Cir. 1978).

C.

Causation requires a showing of "some causal nexus between the defendant's wrongful conduct and [plaintiff's] loss." *St. Louis U. Trust Co., supra* at 1048. Loftsgaarden contends that there is no connection between the misrepresentations and omissions in the offering memorandum and the eventual foreclosure of the motel.[22] The theory advanced appears to be something akin to a contributory negligence defense, in which Loftsgaarden claims that it was acts by plaintiffs themselves that caused foreclosure of the motel. Our answer to this is simply that any direct contribution made by plaintiffs to the demise of the project after they ousted Loftsgaarden as general partner does not relieve him from liability for his own intentional tortious acts. The evidence shows that the numerous misrepresentations and omissions—particularly those relating to financing—unquestionably caused the project to be launched on unsound financial footing. This in itself is sufficient evidence to establish causation. Loftsgaarden is not to be excused from liability because of plaintiffs' inability to extract themselves from a predicament for which he was squarely to blame.

D.

Thus, we uphold the finding of liability on § 10 (b), Rule 10b-5, Ch. 80A. and common law fraud. On the

[22]He further contends that the trial court erred in precluding introduction of evidence surrounding the progress of the project and the decisions which led to its ultimate foreclosure after Loftsgaarden resigned as general partner. We have examined the record and we hold that the evidentiary matters raised by Loftsgaarden had no bearing on the causation issue and were properly excluded for the reasons stated by the lower court at trial.

basis of the foregoing discussion, we also hold that no clear error exists in the lower court's findings of materiality and causation in support of its conclusion that liability exists under § 12 (2). As previously stated, the materiality standard is the same under all the securities statutes. *Alton Box Board Co. v. Goldman, Sachs & Co., supra* at 919-20. Causation under § 12 (2) is shown by demonstrating "some causal relationship" between the misrepresentations or omissions and plaintiffs' purchases. *Id.* at 924. We are nowhere left with the "definite and firm conviction that a mistake has been committed" regarding either of these findings. *United States v. United States Gypsum Co.*, 333 U.S. 364, 395 (1948).

In addition, we reject Loftsgaarden's argument that rescission under § 12(2) was not an available remedy to plaintiffs because no timely demand for rescission nor timely tender of the limited partnership units was made. We do not read § 12(2) as requiring any demand for rescission. All that is required is that the claim be made within the applicable statute of limitations, § 13 of the 1933 Act, 15 U.S.C. § 77m Section 13 requires that action brought under § 12(2) must be brought within one year after the untrue statement or the omission is discovered or should have been discovered and that in no event may an action be brought more than three years after the sale. But even an untimely claim raised under § 12(2) may survive if it is raised in accordance with the relation back rule. Rule 15 (c), F.R.Civ.P.; *see Gridley v. Cunningham*, 550 F.2d 551, 553-54 (8th Cir. 1977); *Gannett Co. v. Register Pub. Co.*, 428 F.Supp. 818, 823 (D. Conn. 1977); *Wassel v. Eglowsky*, 399 F.Supp. 1330, 1358-59 (D. Md. 1975), *aff'd*, 542 F.2d 1235 (4th Cir. 1976); *cf. Straley v.*

Universal Uranium and Milling Corp., 289 F.2d 370, 372-73 (9th Cir. 1961) (relation back of amendment stating claim under § 12 (1)).

It is undisputed that plaintiffs' original complaint, filed on February 26, 1976, was timely. The complaint alleged violations of § 10 (b), Rule 10b-5, and Minnesota securities law. The § 12 (2) claim was raised in subsequent amendments to the complaint filed on December 26, 1978, and May 18, 1979. It is also undisputed that the § 12 (2) claim "arose out of the conduct, transaction, or occurrence set forth . . . in the original pleading." Rule 15 (c), F.C.Civ.P. Accordingly, the § 12(2) claim was timely raised because the amendments related back to the date of the original pleading. *Id. See generally* C. Wright & A. Miller, *Federal Practice and Procedure* § 1497 at 499-500 (1971).

Nor are we persuaded that plaintiffs' claim under § 12 (2) should be barred because no tender of the limited partnership units was made until shortly before trial. No time for tender is prescribed by § 12(2) and this circuit has held that a tender prior to or during trial satisfies the requirement. *Gridley v. Cunningham, supra* at 554; *see also Wigand v. Flo-Tek, Inc.*, 609 F.2d 1028, 1034-35 (2d Cir. 1979).

III.

Before addressing damages, we briefly consider and reject two tangential points raised by Loftsgaarden. One point concerns an allegedly prejudicial remark made by the court to Loftsgaarden's counsel. At the end of the first day of trial, the court limited counsel's cross-examination of Crawford to an amount of time equal to that consumed

by plaintiffs in their direct examination. When counsel for Loftsgaarden balked, the court stated, "I don't want to be critical but you spent 15 minutes on minor historical meetings." T. 143. The following day, Loftsgaarden moved for a mistrial alleging the court's comment constituted judicial misconduct, irreparably prejudicing the rights of the defendants. It is claimed the lower court erred in denying the motion. We cannot say that such an incidental remark in any way reflected any conscious or unconscious desire on the part of the trial court to deprive Loftsgaarden of a fair trial. *Cf. Agee v. Lofton*, 287 F.2d 709, 710 (8th Cir. 1961) ("[The trial judge's] remarks making light of the plaintiffs and their witnesses were, in our opinion, calculated to prevent the plaintiffs from having the sort of trial to which they were legally entitled."). Furthermore, any possible prejudice was cured by the court in its instructions to the jury.[22]

The second point raised is that the lower court abused its discretion in permitting plaintiffs to introduce evidence of a prior fraud committed by Loftsgaarden. After Loftsgaarden denied any intent to defraud plaintiffs, the court permitted plaintiffs to rebut this testimony by introducing evidence of a 1976 state court determination that Loftsgaarden had defrauded a party in a real estate transaction. The lower court concluded that the evidence was probative of intent and that its value in this regard outweighed any prejudice. *See* Fed.R.Evid. 403. A limiting instruction

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[22]The jury was told:

> It is the duty of the Court to admonish an attorney who, out of zeal for his cause, does something which is not in keeping with the rules of evidence or procedure. You are to draw no inference against the side to whom an admonition of the Court may have been addressed during the trial of the case.

T. 782.

was given in which it was made clear that the evidence "was received only as it may relate to [Loftsgaarden's] intent and for no other purpose." Once Loftsgaarden denied any intent to defraud, it was within the trial court's discretion to permit evidence of the prior fraud. *See Fed.* R.Evid. 404 (b). We hold that the court did not abuse its discretion in allowing this evidence to be placed before the jury.

IV.

The most hotly contested issue in this case concerns the district court"s ruling that Loftsgaarden could not introduce any evidence about the tax benefits accruing to plaintiffs as a result of their participation in Alotel Associates. Loftsgaarden argues that the evidence was crucial to the issue of whether plaintiffs, regardless of whether they had been defrauded, suffered any actual damages.

A.

"[D]amages for securities fraud are determined in accordance with the extent to which false and misleading information actually harmed the complaining party. . . ." *Shapiro v. Midwest Rubber Reclaiming Co.*, 626 F.2d 63, 69 (8th Cir. 1980), *cert. denied*, 449 U.S. 1079 (1981); *cf.* 15 U.S.C. § 78bb (a) (limiting plaintiff's recovery under the 1934 Act to "actual damages on account of the act complained of"). Failure by the complaining party to prove actual damages is fatal to the party's claim. *Shapiro, supra* at 70. Generally, the out-of-pocket measure of damages is applied in securities fraud cases, usually awarding plaintiff (in the case of a defrauded purchaser) the difference between the purchase price of the security

and its actual value on the date of purchase.[24] *Harris v. American Investment Co.*, 523 F.2d 220, 225 (8th Cir. 1975), *cert. denied*, 423 U.S. 1054 (1976). This measure, however, is "not a talisman"; the function of the court "is to fashion the remedy best suited to the harm." *Garnatz v. Stifel, Nicolaus & Co.*, 559 F.2d 1357, 1360 (8th Cir. 1977), *cert. denied*, 435 U.S. 951 (1978). Accordingly, a rescissional remedy, *id.*, or some other measure of damages in the nature of restitution may be applied. *Cf. Myzel v. Fields*, 386 F.2d 718, 742-43 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968) ("Rescission calls for cancellation of the bargain, and the return of the parties to the *status quo ante;* . . . [b]ut where there exists no market value of the stock, the stock is no longer in existence, and there clearly has been a fluctuation in value . . ., then what restitutional damages are to be awarded must depend upon the facts of the particular case.").

The actual damages principle requires that a rescissional or restitutional award be "reduced by any value received as a result of the fraudulent transaction." *Garnatz v. Stifel, Nicolaus & Co., supra* at 1361. This principle applies in the instant case not only to the § 10 (b) and Rule 10b-5 claims, but also to the claims under * 12(2) and Minnesota law. Under § 12(2), the defendant guilty of prospectus fraud shall be liable to plaintiff,

> who may sue either at law or in equity in any court of competent jurisdiction, to recover the considera-

[24]Where fraud is found to have affected the open market price of the security because others were influenced by the same misrepresentations made to the person seeking recovery, the measure applied is the difference between the purchase price and the actual value on the date of discovery of the fraud. *Harris v. American Investment Co.*, 523 F.2d 220, 226 (8th Cir. 1975), *cert. denied*, 423 U.S. 1054 (1976).

> tion paid for such security with interest thereon, *less the amount of any income received thereon,* upon the tender of such security, or for damages if he no longer owns the security.

15 U.S.C. § 77*l* (emphasis added). Similarly, the Supreme Court of Minnesota holds that the defrauded party is entitled to no recovery unless plaintiff is able to prove that he suffered actual damages as a result. *Berg v. Xerxes-Southdale Office Bldg. Co.*, 290 N.W.2d 612, 615 (Minn. 1980); *cf.* Minn. Stat. § 80A.23 (limiting recovery to actual damages sustained for violation of state securities laws).

At trial Loftsgaarden attempted to show that in spite of any fraud he may have perpetrated, plaintiffs suffered no actual damages because of the tangible economic benefit they derived from the limited partnership units in the form of large tax write-offs which they used to offset their sizeable professional incomes. Loftsgaarden's offer of proof indicates that he was prepared to introduce evidence that three of the four plaintiffs suffered no actual damages on account of the tax savings they experienced from the investment. The district court stated that it was "not going to get into a lot of complicated tax testimony" (T. 23), and disallowed the evidence, dismissing the argument as "sophistic malarky." D.R. 438. The court concluded that the limited partnership units were worthless and instructed the jury that if they found liability, the measure of damages would be the amount "which the plaintiffs paid out in reliance upon the false representations of [the] defendant . . ." T. 805. We take no issue with the court's decision to apply what was essentially a rescissory

measure of damages in this case,[23] but we hold that the court committed reversible error in refusing to allow proof of any economic benefits received by plaintiffs on account of the investment and in failing to instruct the jury that the damage award must be reduced by any value shown to have been received by plaintiffs.

V.

We have already explained the basic principles of real estate tax shelter investment in Part I of this opinion. The aim is to generate large amounts of artificial losses in the early years of the investment which may be passed on to the limited partners for use in offsetting their outside income. The ultimate goal, of course, is to establish a positive cash flow and become an income-producing enterprise, which income—just as the early losses—is distributed proportionately to the limited partners. Thus the benefits from a profitable real estate tax shelter investment are two-fold, offering tax savings to the limited partner in its early years and generating income in later years. But unlike a corporate shareholder, for example, even if the enterprise fails to become profitable, the limited partner clearly may have something of value because of the investment's unique tax treatment:

> A limited partner who has been misled into investing in an unprofitable real estate venture may be in a better position than a shareholder in an unprofitable

[23] Accordingly, there is no merit to Loftsgaarden's contention that the lower court erred in failing to submit to the jury the issue of when plaintiffs discovered the fraud. Loftsgaarden contends that jury determination of the question was "crucial to the issue of damages." Brief at 38. But in the context of damages, the time of discovery of the fraud is crucial only where the out-of-pocket measure is to be applied and the trier of fact is obliged to value the security as of this date.

> corporation. By use of depreciation, real estate limited partnerships can generate a substantial tax loss while actually taking in sufficient cash to cover partnership expenses. This tax loss can be passed through to the partners as a shelter for other taxable income. In the extreme case where the partnership's gross rents are exactly equal to its expenditures, the tax loss continues to make the partnership an attractive investment. On the other hand, the stock of a corporation having no profit or prospects of profit would be worthless, and a shareholder in that corporation would value any recovery in a civil suit more than his investment.

Note, *Real Estate Limited Partnerships and Allocational Efficiency: The Incentive to Sue for Securities Fraud*, 63 Va.L.Rev. 669, 672-73 (1977) (footnotes omitted). We note that the above excerpt discusses the value of the limited partnership interest in a break-even investment. Whether or not the costs exceeded the benefits in the instant case where the enterprise never even reached the break-even point cannot be determined absent evidence on the matter.

The few recent cases addressing the issue hold that in private securities fraud actions brought by limited partners in real estate tax shelter investments, consideration of tax benefits received by the limited partners is relevant to the question of whether plaintiffs suffered any actual damage. In *Bridgen v. Scott*, 456 F.Supp. 1048 (S.D. Tex. 1978), limited partners sued the general partner under § 10 (b) and Rule 10b-5 after they received tax benefits, but no profit upon a speculative real estate investment.

The court permitted defendant to introduce evidence of the tax aspects of the investment:

> Requiring the jury or this Court to try this case without reference to the tax consequences of the transaction would be requiring the jury and the Court to live in an artificial "never-never land." The plaintiffs' position that the tax consequences of this transaction should be ignored is simply not realistic and is tantamount to requesting this Court and the jury to try this case blindfolded.

Id. at 1061. The court held that application of a rescissory damage measure would require reduction of the price paid by the specific value received by plaintiffs in the form of tax write-offs. *Id.* at 1060. In *Smith v. Bader*, 83 F.R.D. 437 (S.D.N.Y. 1979), the court permitted discovery of plaintiffs' tax returns, holding that "knowledge of plaintiffs' income tax rate and the net value of their investment, along with other information, may be needed to calculate any tax benefits which may mitigate damages'" *Id.* at 439. Similarly, in *Berg v. Xerxes-Southdale Office Bldg. Co supra*, at 615, the court held that in valuing the interest in a real estate limited partnership, income tax considerations are relevant. *Cf. Dupuy v. Dupuy*, 551 F.2d 1005, 1025 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); *Bayoud v. Ballard*, 404 F.Supp. 417, 426 (N.D. Tex. 1975); *Hickman v. Groesbeck*, 389 F.Supp. 769, 779-80 (D. Utah 1974). Indeed, the tax aspects of a real estate limited partnership investment are of such tangible economic benefit to the investor that damages are recoverable under the securities laws where, on account of fraud by the offeror, tax write-offs taken by the investor are disallowed by the

Internal Revenue Service. *Sharp v. Coopers & Lybrand, supra.* Thus, we acknowledge the value of the tax deductions generated by such an investment and hold that the strictly compensatory nature of damages awardable in private securities fraud actions requires that such value be taken into account in determining whether and to what extent damages were inflicted upon plaintiffs.

The lower court's allusion to the complexity of evidence relating to plaintiffs' tax savings is not a viable reason for precluding such evidence in light of *Norfolk & Western R. Co. v. Liepelt,* 444 U.S. 490 (1980). In the context of a wrongful death action under the Federal Employer's Liability Act (FELA),[26] the Court held that it was error to preclude evidence of the income tax payable on the decedent's past and estimated future earnings and to refuse to instruct the jury that the award of damages would not be subject to income taxation. While admitting that many variables affect the amount of a wage earner's future income tax liability, the Court observed that the calculation was no more uncertain or complex than that already made by juries in determining future earnings. The Court concluded, "We therefore reject the notion that the introduction of evidence describing a decedent's estimated after-tax earnings is too speculative or complex for a jury." *Id.* at 494.

In the case before us, it is likely that the jury will not even be faced with the vagaries of calculating future income tax liability. Loftsgaarden's offer of proof indicated that he was prepared to show, based on an analysis of plaintiffs' income tax returns for the years 1973 to 1978, that three out of the four plaintiffs were net dollars ahead

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[26] 45 U.S.C. §51 *et seq.*

after foreclosure of the investment. All plaintiffs except Dr. Randall reported the proceeds from the foreclosure in their 1978 tax returns.[27] Thus, the net affect of the investment is subject to proof without the need for the jury to speculate about the impact of any future recoupment of the losses deducted. This is not to say that the present damage calculation is entirely devoid of speculation. Plaintiffs did indicate that their returns for the years 1973 to 1978 were undergoing audits by the Internal Revenue Service. Evidence of the audit and expert opinions as to its likely results are admissible at the retrial on damages. Certainly the possibility that past tax deductions will be disallowed is relevant to the determination of the extent of any benefit actually received by plaintiffs from those deductions. The jury is entitled to determine whether and to what extent there would be a disallowance of deductions.

We wish to clarify that the impact of our holding is not nearly so far-reaching as plaintiffs predict. They argue that because there are tax consequences to any investment one makes, evidence of those consequences will not figure in every securities fraud case. But our holding applies only to cases involving investments that are expressly marketed and sold as tax shelters. That is, investments which allow the investor

> to offset certain "artificial losses" (that is, noneconomic losses but losses which are available as deductions under the present tax laws) not only against the income from those investments but also against

[27]It is safe to assume that by this time, Dr. Randall has also reported the extent of his proportional share of the proceeds from the foreclosure. Even if he has not so reported, the extent of his share certainly is either known or discoverable.

> the [investor's] other income, usually from his regular business or professional activity.

Staff of Joint Comm. on Internal Revenue Taxation, 94th Cong., 1st Sess., *Overview of Tax Shelters* 1 (Comm. Print 1975).

In conclusion we hold that in a private securities fraud action involving an investment structured and marketed as a tax shelter, where a rescissory measure of damages is applied, evidence of any benefit derived by the plaintiff/investor via tax savings must be permitted.

V.

For the foregoing reasons, we vacate the award of damages and remand to the district court for a new trial on that issue.[28] In all other respects, the judgment of the district court is affirmed.

A true copy.

Attest:

CLERK, U. S. COURT OF APPEALS, EIGHTH CIRCUIT.

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[28] Accordingly, it is unnecessary for us now to address issues raised regarding the awards of prejudgment interest and attorneys' fees.

APPENDIX E

Dr. Roger E. Austin, Dr. Thomas W. Anderson, Dr. Myrel A. Neumann and Dr. William C. Randall,

Plaintiffs,

vs.

B. J. Loftsgaarden, M. S. Noah, Lyman H. Coult, Alotel Inc., a Minnesota corporation, Property Development & Research Co., a Minnesota corporation, and 2361 Building Corp., a Minnesota corporation,

Defendants.

FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER FOR JUDGMENT

No. 4-76- Civ. 82

INTRODUCTION

This securities fraud case proceeded to trial and the jury found for the plaintiffs on the 10b-5, Minn. Stat. § 80A.23 and common law fraud claims. The § 12(2) count was to be decided by the Court and was submitted to the jury for an advisory verdict. The jury also found for the plaintiffs on this count. The Court accepts the jury's verdict and adopts the propposed findings of fact and conclusions of law submitted by plaintiffs, as modified below.

FINDINGS OF FACT

1. Defendants B. J. Loftsgaarden ("Loftsgaarden") and Alotel Incorporated offered to sell and did sell limited partnership units in Alotel Associates, a Minnesota limited

partnership, to plaintiffs Dr. Roger E. Austin ("Austin"), Dr. Thomas W. Anderson ("Anderson"), Dr. Myrel A. Neumann ("Neumann"), and Dr. William C. Randall ("Randall"). The offers were made and the sales were accomplished by means of a document which was denominated "Offering Memorandum."

2. The Offering Memorandum included the following statements.

(a) The Offering Memorandum stated that it was then presently contemplated that interim construction financing would be obtained from the First National Bank of St. Paul at an interest rate of 9-1/2% per annum.

(b) The Offering Memorandum stated that projected construction loan interest would be $130,000.

(c) The Offering Memorandum stated that the land on which the motel project was to be built had been leased for an initial term of 40 years with renewal options extending thereafter.

(d) The Offering Memorandum stated that it was anticipated that construction of the project would begin in May of 1973, that construction would be completed by December of 1973 and that the motel might be opened for occupancy in December of 1973.

(e) The Offering Memorandum stated that it was then contemplated that Alotel Associates would enter into a construction contract for the construction and furnishing of the motel for a total expenditure of $3,150,000 (including certain expenditures which were to be treated as partnership expenses for tax purposes).

(f) The Offering Memorandum stated that it was

then projected that the developer and the construction company would receive a total of $103,900 for "overhead and profit."

(g) The Offering Memorandum stated that it assumed that a $240,000 five-year 8% loan would be obtained in January of 1974.

(h) The Offering Memorandum stated that Alotel Associates had procured a firm commitment for long-term financing of the project from Larwin Realty & Mortgage Trust ("Larwin").

(i) The Offering Memorandum included various budgets and forecasts.

3. The following facts were known to Loftsgaarden and Alotel Incorporated:

(a) On February 15, 1973, Loftsgaarden filed an application with First National Bank of St. Paul for interim construction financing for Defendant Property Development & Research Company ("PDRC"). The rate of interest to be charged pursuant to that commitment was one which would float at 4% per annum over the prime rate charged by First National Bank of St. Paul. Subsequently First National Bank of St. Paul issued a commitment on the terms stated. Between December 27, 1972, and February 25, 1973, the prime rate charged by First National Bank of St. Paul was 6%. Between February 26, 1973, and March 18, 1973, the prime rate was 6-1/4%. Between March 19, 1973, and May 6, 1973, the prime rate was 6-3/4% .Between May 7, 1973 and May 24, 1973, the prime rate was 7%. Between May 25, 1973, and June 6, 1973, the prime rate was 7-1/4%. Between June 7, 1973, and June

20, 1973, the prime rate was 7-1/2%. Between June 21, 1973, and July 1, 1973, the prime rate was 7-3/4%. Between July 2, 1973, and July 5, 1973, the prime rate was 8%. Between July 6, 1973, and July 17, 1973, the prime rate was 8-1/4%. Between July 18, 1973, and July 26, 1973, the prime rate was 8-1/2%. Between July 27, 1973, and August 5, 1973, the prime rate was 8-3/4%. Between August 6, 1973, and August 12, 1973, the prime rate was 9%. Between August 13, 1973, and August 19, 1973, the prime rate was 9-1/4%. Between August 20, 1973 and August 26, 1973, the prime rate was 9-1/2%. Between August 27, 1973 and September 13, 1973 the prime rate was 9-3/4%. Between September 14, 1973, and February 6, 1974, the prime rate was 10%.

(b) The projected construction loan interest depended upon the prime rate's remaining at 9-1/2% per year and completion of the construction of the motel on December 31, 1973. Construction of the motel began in June of 1973. Loftsgaarden and Alotel Incorporated anticipated that it would require at least one (1) year to complete construction of the motel.

(c) Alotel Associates was never a party to a lease for an initial term of forty (40) years with renewal options. On October 24, 1973, Alotel Associates became a party to a lease with an initial term of fifteen (15) years with a fifteen-year renewal option. That lease contained no option to purchase.

(d) Loftsgaarden and Alotel Incorporated never caused Alotel Associates to execute a contract for the construction and furnishing of the motel for a total expenditure of $3.150,000 (including certain expendi-

tures which were to be treated as partnership expenses for tax purposes) and did not contemplate that they would cause Alotel Associates to enter into such a construction contract.

(e) Loftsgaarden submitted construction estimates to First National Bank of St.Paul and Larwin Realty and Mortgage Trust ("Larwin") in which he stated that he, PDRC or Defendant 2361 Building Corporation ("2361") expected that "overhead" would total $61,668 and that "contingency and profit" would total $254,900.

(f) On July 31, 1973, Loftsgaarden had obtained a commitment for a five-year $240,000 loan. The commitment provided that the interest rate would float at up to 3% over the prime rate.

(g) Alotel Associates would not be able to make use of the commitment from Larwin because of conditions contained in the commitment.

4. The statements set forth in Paragraph 2 were untrue and were statements of material fact.

5. The Offering Memorandum omitted to state the following facts:

(a) It was contemplated that interim construction financing would be obtained from First National Bank of St. Paul at an interest rate which would float at 4% over the prime rate charged by First National Bank of St. Paul and that the prime rate would continue to exceed 5-1/2% per annum.

(b) Projected construction loan interest was dependent upon the prime rates remaining at 5-1/2% per annum and the completion of construction of the motel project on December 31, 1973.

(c) Construction of the motel project had begun in June of 1973.

(d) Projected construction loan interest was dependent upon the completion of construction of the motel in seven (7) months. Loftsgaarden, Alotel Incorporated, PDRC and 2361 expected that construction of the motel would require at least one year.

(e) The $240,000 five-year loan was to be secured by a chattel mortgage of the furniture, fixtures, and some of the equipment of the motel.

(f) The $240,000 five-year loan was to be obtained at a rate of interest which would float at up to 3% per annum over the prime rate charged by the First National Bank of Rochester.

(g) Larwin's commitment for long-term financing of the project was dependent upon Larwin's obtaining of a satisfactory opinion from a Minnesota attorney of its choice that the loan to Alotel Associates would not be usurious.

(h) The risk that the loan from Larwin to Alotel Associations would be found to be usurious was so substantial that Larwin would be able either to refuse to honor its commitment or to insist upon certain conditions which would impose substantial additional costs and risks upon Alotel Associates.

(i) Loftsgaarden had not and would not fund Alotel Incorporated and did not intend that Alotel Incorporated would ever become either an active or a financially responsible general partner of Alotel Associates.

(j) Loftsgaarden did not state that certain of the persons whom the Offering Memorandum had identified

as directors and officers of Alotel Incorporated had not agreed to become active directors and officers.

(k) Loftsgaarden was the sole shareholder of PDRC.

(l) PDRC held options to purchase or the fee interest in most of the tracts of land upon which the motel was to be constructed.

(m) Loftsgaarden, Alotel Incorporated and PDRC intended and expected that PDRC would earn a substantial profit through PDRC's acquisition and sale of the land upon which the motel was to be constructed.

(n) Loftsgaarden owned 30% of the outstanding shares of stock of arc-TECH, inc., the corporation which was to act as the architect in connection with the design and construction of the motel project and which was to earn a fee of $90,000.

(o) Loftsgaarden, Alotel Incorporated, PDRC and 2361 intended and expected that they would receive compensation which would be considerably in excess of the "overhead and profit" which was projected in the Offering Memorandum.

(p) Loftsgaarden, Alotel Incorporated and PDRC intended and expected that PDRC would be paid a commitment fee by Alotel Associates for obtaining financing for the motel project.

(q) Paul D. Crawford ("Crawford"), a person who was purporting to act as an investment advisor to Austin, Anderson and Neumann in connection with Loftsgaarden's and Alotel Incorporated's offers to sell and sales of limited partnership units in Alotel Associates, was not licensed to act as an investment advisor. Crawford, whom Loftsgaarden had caused 2361 to

hire and whom Loftsgaarden had caused to offer to sell and to sell a limited partnership in Alotel Associates to Randall, had had his license to sell securities suspended by the Commissioner of Securities of the State of Minnesota.

(r) The budgets and forecasts contained in the Offering Memorandum were based upon assumptions and a rational that were not reasonable and were misleading in light of the facts known to Loftsgaarden, Alotel Incorporated, PDRC and 2361.

6. The omitted facts set forth in Paragraph 5 were material facts.

7. The omitted facts set forth in Paragraph 5 were material facts.

8. Loftsgaarden's and Alotel Incorporated's offers and sales of limited partnership units in Alotel Associates to Anderson, Austin, Neumann and Randall were made and accomplished by the use of means and instruments of transportation and communication in interstate commerce and of the mails.

9. At the time that Anderson purchased his limited partnership unit in Alotel Associates, he did not know of the omitted facts set forth in Paragraph 5 and did not know that any of the untrue statements set forth in Paragraph 2 were false.

10. At the time that Austin purchased his limited partnership unit in Alotel Associates, he did not know of the omitted facts set forth in Paragraph 5 and did not know that any of the untrue statements set forth in Paragraph 2 were false.

11. At the time that Neumann purchased his limited partnership units in Alotel Associates, he did not know of

the omitted facts set forth in Paragraph 5 and did not know that any of the untrue statements set forth in Paragraph 2 were false.

12. At the time that Randall purchased his limited partnership unit in Alotel Associates, he did not know of the omitted facts set forth in Paragraph 5 and did not know that any of the untrue statements set forth in Paragraph 2 were false.

13. Loftsgaarden and Alotel Incorporated have not sustained the burden of proof that they did not know and in the exercise of reasonable care could not have known of the untrue statements and omissions set forth in Paragraph 2 and 5 because of the following:

(a) At the time that the Offering Memorandum was prepared and at the time of the sales to Anderson, Austin, Neumann and Randall, Loftsgaarden knew that the interim construction financing would be obtained only at a rate which would float at 4% per annum over the prime rate charged by First National Bank of St. Paul.

(b) At the time that the Offering Memorandum was prepared and at the times of the sales to Anderson, Austin, Neumann and Randall, Loftsgaarden knew that the total projected construction loan interest of $130,000 depended upon the prime rates remaining at 5-1/2% per year and the completion of construction of the motel on December 31, 1973, that the prime rate had risen above 5-1/2% per annum and that construction of the motel would require at least one year and would not be completed until long after December 31, 1973.

(c) At the time that the Offering Memorandum was prepared and at the times of the sales to Anderson,

Austin, Neumann and Randall, Loftsgaarden knew that Alotel Associates had not executed a 40-year lease with renewal options extending thereafter with respect to the land on which the motel was to be constructed.

(d) On October 24, 1973, Loftsgaarden knew that Alotel Associates had executed a 15-year lease with a 15-year renewal option.

(e) At the time that the Offering Memorandum was prepared and at the times of the sales to Anderson, Austin, Neumann and Randall, Loftsgaarden knew that construction of the motel was expected to take at least one year.

(f) In June 1973 and thereafter, Loftsgaarden knew that the $240,000 five-year loan would be obtained at an interest rate which would float above the prime rate, that the interest rate might be as much 3% per annum above the prime rate and that the loan would be secured by a chattel mortgage of the furniture, fixtures and certain of the equipment at the motel.

(g) In June 1973 and thereafter, Loftsgaarden knew that Larwin would not make long term financing available directly to Alotel Associates because charging Alotel Associates interest at 9-1/2% per annum would be usurious under Minnesota law and that Larwin would make such a loan only through a nominee.

(h) At the time that the Offering Memorandum was prepared and at the times of the sales to Anderson, Austin, Neumann and Randall, Loftsgaarden knew that he would not cause 2361, the general contractor, to enter into a contract with Alotel Associates for the construction and furnishing of the motel for total expenditure of $3,150,000 (including certain expenditures

which would be treated as partnership expenses for tax purposes).

(i) At the time that the Offering Memorandum was prepared and at the times of the sales to Anderson, Austin, Neumann and Randall, Loftsgaarden knew that he had not caused and did not intend to cause Alotel Incorporated to be funded and that he did not intend Alotel Incorporated ever to become an active or financially responsible general partner of Alotel Associates.

(j) At the time that the Offering Memorandum was prepared and at the times of the sales to Anderson, Austin, Neumann and Randall, Loftsgaarden knew that he expected that he and/or PDRC expected to earn a profit through the acquisition and sale of the land upon which the motel was to be constructed.

(k) At the time the Offering Memorandum was prepared and at the time of the sales to Anderson, Austin, Neumann and Randall, Loftsgaarden knew that he owned 30% of the outstanding stock of arc-PECH, inc., that arc-TECH, inc., was to be the architect involved in designing and supervising construction of the motel and that arc-Tech, inc., would earn a fee of $90,000.

(l) At the time that the Offering Memorandum was prepared, Loftsgaarden knew that he intended that either he or his companies expected to receive compensation and profits in excesss of $240,000 as a result of the development of the motel for Alotel Associates.

(m) Loftsgaarden knew that Alotel Associates would pay PDRC a commmitment fee for obtaining long-term financing for the motel project.

(n) At the time that the Offering Memorandum was prepared and at the times of the sales to Anderson, Austin, Neumann and Randall, Loftsgaarden knew that Crawford was not licensed to act as an investment advisor. In October 1973, Loftsgaarden knew that the Commissioner of Securities of the State of Minnesota had suspended Crawford's license to sell securities.

(o) At the time the Offering Memorandum was prepared and at the times of the sales to Anderson, Austin, Neumann and Randall, Loftsgaarden knew that the budgets and forecasts contained in the Offering Memorandum were based upon assumptions and a rationale that were not reasonable and which were misleading in light of the facts known to him.

14. At all relevant times, Loftsgaarden was the president, a director, the sole shareholder and a controlling person of Alotel Incorporated, PDRC and 2361.

15. Anderson, Austin, Neumann and Randall relied upon the Offering Memorandum, including the untrue statements contained therein, in making their purchases of limited partnership units in Alotel Associates. Such reliance was either direct, indirect through an advisor who directly relied upon the Offering Memorandum or a combination of both.

16. There was a causal relationship between the Offering Memorandum's inclusion of the untrue statements set forth in Paragraph 2 and omission of the facts set forth in Paragraph 5 and Anderson's, Austin's, Neumann's and Randall's purchases of limited partnership units in Alotel Associates.

17. There was no causal connection between the defendants' fraud and plaintiffs' loans to the partnership.

18. Dr. Anderson purchased one limited partnership unit of Alotel Associates on June 2, 1973, for $35,000. Dr. Austin purchased one unit on June 26, 1973, for $35,000. Dr. Neumann purchased one unit on August 21, 1973, for $35,000. He purchased one-half unit on October 19, 1973, for $17,500. Dr. Randall purchased one unit on November 23, 1973 for $35,000.

19. In March 1975, Anderson, Austin, Neumann, Randall and the other investors in Alotel Associates retained John Essene, a certified public accountant, in an effort to obtain accurate financial information concerning Alotel Associates.

20. In July 1975, Anderson, Austin, Neumann, Randall and the other investors in Alotel Associates retained Gene Happe, an attorney, to investigate the financial affairs of Alotel Associates.

21. Retention of John Essene and Gene Happe followed Anderson's, Austin's, Neumann's and Randall's first suspicions that there was something amiss concerning the financial affairs of Alotel Associates and constituted the exercise of reasonable diligence to discover the untrue statements set forth in Paragraph 2 and the omissions set forth in Paragraph 5.

22. Plaintiffs discovered or should have discovered defendants' fraud some time in August-September 1975. The original complaint in this action was filed on February 24, 1976.

23. At the time that Anderson, Austin, Neumann and Randall discovered that the Offering Memorandum contained untrue statements of material fact and omitted to state material facts, the limited partnership units in Alotel Associates which they had purchased were valueless.

24. Anderson, Austin, Neumann and Randall have tendered the limited partnership units in Alotel Associates which they had purchased to Loftsgaarden and Alotel Incorporated.

CONCLUSIONS OF LAW

1. The Court has subject matter jurisdiction over this action.

2. The limited partnership units of Alotel Associates purchased by the plaintiffs were securities.

3. B. J. Loftsgaarden and Alotel Incorporated offered or sold a security by the use of means or instruments of transportation or communication in interstate commerce or of the mails; by means of a prospectus or oral communication, which included an untrue statement of a material fact and omitted to state a material fact necessary in order to make the statements not misleading. This conduct is a violation of 15 U.S.C. § 77*l* (2).

4. None of the plaintiffs knew at the time of such offer or such sale of the untruths or omissions.

5. B. J. Loftsgaarden and Alotel Incorporated knew or in the exercise of reasonable care should have known of such untruths or omissions.

6. Although reliance is not a necessary element of a § 12(2) action, plaintiffs did rely on the defendants' untrue statements.

7. Although reliance is not an element of the § 12(2) action, there must be a showing of some causal connection between the defendants' wrongful conduct and the plaintiffs' purchases. *Sanders v. John Nuveen & Co.*, 619 F.2d 1222, 1225 (7th Cir. 1980); *Alton Box Board Co. v. Goldman, Sachs & Co.*, 560 F.2d 916, 924 (8th Cir. 1977);

Eriksson v. Galvin, 484 F.Supp. 1108, 1121 (S.D .N.Y. 1980). Plaintiffs have established this connection in regard to their purchases of the limited partnership units, but did not establish the requisite connection in regard to their loans to the partnership.

8. Plaintiffs brought this action within one year after the discovery of the untrue statements or the omissions or within one year after such discovery should have been made by the exercise of reasonable diligence. The plaintiffs also commenced this action within three years after the date of the sale of the limited partnership units to them. The Court was persuaded by the evidence produced at trial that the plaintiffs could have discovered the fraud in August-September of 1975. Even if some of defendants' arguments were accepted, the earliest discovery date would be about March of 1975. This action would still have been timely since the complaint was filed in February 1976.

9. It is generally an equitable requirement of rescission that a tender of the security be made to the defendants. Plaintiffs here did not make such a tender until shortly before trial. Such a tender could be appropriate under any circumstances. *See Gridley v. Cunningham*, 550 F.2d 551, 554 (8th Cir. 1977). By the time the plaintiffs here had learned of the fraud, their securities were worthless and a tender was essentially futile. There was no showing that defendants would have repurchased the units at that time. Under these circumstances it is impossible to restore the status quo by tender, and plaintiffs are not barred from recovery merely because they did not tender until shortly before trial. *See Wigand v. Flo-Tek*, 609 F.2d 1028, 1035 (2d Cir. 1979).

10. Pursuant to section 12(2) of the Securities Act of

1933, plaintiffs are entitled to recover the consideration paid for the limited partnership units.

11. Plaintiffs are also entitled to prejudgment interest in the amounts set forth in the Court's post-trial Order on the other counts.

ORDER FOR JUDGMENT

IT IS ORDERED THAT:

1. Judgment is entered for the same plaintiffs and against the same defendants on the § 12 (2) count in accordance with the Judgment entered on June 25, 1980, and the Memorandum Order entered August 15, 1980.

2. The Court has found defendants liable to plaintiffs on the § 12(2) claim. The jury found defendants liable on the 10b-5, Minnesota Statutes § 80A.23 and common law fraud claims. Any of these counts independently supports defendants' liability; but each plaintiff is entitled only to a single recovery. In addition, as further explained in today's post-trial Order on the jury verdict, only the § 12 (2) and Minnesota Statutes § 80A.23 count supports the award of prejudgment interest; and only the Minnesota Statutes § 80A.23 count supports the award of attorneys' fees.

August 15, 1980.

/s/ Earl R. Larson
United States Senior District Judge

APPENDIX F

(Title of Cause.)

MEMORANDUM ORDER
No. 4-76-riv. 82

The plaintiffs here were investors in a limited partnership. They sued the seller of the partnership units for securities and common law fraud. After trial, the jury returned verdicts in favor of plaintiffs on the 10b-5, Minn. Stat. § 80A.23 and common law fraud claims. Both plaintiffs and defendants have made a number of post-trial motions.

DEFENDANTS' MOTION FOR A NEW TRIAL OR JUDGMENT NOTWITHSTANDING THE VERDICT

Defendants contend that there was insufficient evidence to support the jury's findings of materiality, reliance or causation. Although defendants' brief refers only to the 10b-5 claim, the argument is apparently also addressed to the State securities law and common law fraud claims.

The materiality requirement serves two functions. It protects sellers and buyers of securities from having to disclose every picayune fact which might be related to the transaction. It also has an important role in the determination of causation, particularly in nondisclosure or omission cases. A misrepresentation or omitted fact is material if there is a substantial likelihood that a reasonable purchaser would consider it important or would give it actual significance in making his investment decision. *TSC Industries, Inc. v. Northway, Inc.*, 426 U S. 438. 449 (1976). The reliance requirement encompasses whether the particular

plaintiff did consider the misrepresentation or omission important or significant, or whether he would have made the same decision even if he had known the full truth. The only purpose of this element is to aid in ensuring the presence of causation. Causation involves a determination that the misrepresentation or nondisclosure by the defendant led to the plaintiff's loss.

When a misrepresentation is the basis for a plaintiff's claim, he must show reliance. The Eighth Circuit has held that this rule applies to misstatements and half-truths, which have the same essential nature as misrepresentations.[1] *Vervaecke v. Chiles, Heider & Co.*, 578 F.2d 713, 717 (8th Cir. 1978). A different rule, however, has long been followed when the defendant's wrongful conduct consists of a failure to disclose a material fact. In this circumstance, because plaintiffs can hardly be expected to prove actual reliance on what does not exist; a presumption of reliance arises.[2] *Affiliated Ute Citizens v. United*

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[1]Defendants argue that there are not true omissions in this case, and therefore the *Vervaecke* rule applies. Defendants have mischaracterized the nature of this case and the *Vervaecke* holding. There were omissions here aside from any misstatements or half-truths. *Vervaecke* is not a model of clarity, but if its holding were as defendants claim, it would conflict with *Affiliated Ute*, and well-reasoned decisions in other circuits. The whole question of omissions is largely irrelevant because the jury found reliance on the affirmative misrepresentations and that, coupled with the finding of causation, is sufficient to justify the defendants' liability.

[2]The presumption of reliance has also been found in circumstances where the defendants' fraud depresses secondary market value. *See Shores v. Sklar*, 610 F.2d 235, 239 (5th Cir. 1980). In addition, *Shores v. Sklar* eliminated the need for reliance where the fraud was a major cause for the security being sold at all. 610 F.2d at 240. That reasoning could properly be extended to this case. A first attempted offering failed miserably. The second offering, reworked and replete with misrepresentations and omissions, succeeded in attracting investors. Unless it did attract a certain number of purchasers, by its own terms the offering would not result in formation of a limited partnership. Therefore, the reliance of the various investors could be viewed as interwoven. Case law seems to recognize that where causation is clearly established, reliance becomes largely irrelevant. That situation may be present here.

States, 406 U.S. 128, 153 (1972); *Continental Grain, Ltd. v. Pacific Oilseeds, Inc.*, 582 F.2d 409, 412 n.1 (8th Cir. 1979). The fairness of this rule stems from the fact that the defendant has created the problem by failing to disclose the material fact.[3] Of course, defendants may introduce evidence to rebut this presumption. *Shores v. Sklar*, 610 F.2d 235, 239 (5th Cir. 1980); *St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 562 F.2d 1040, 1049 (8th Cir. 1977), *cert. denied*, 435 U.S. 925 (1978).

When an affirmative misrepresentation is alleged, causation is proved by showing that the plaintiff relied on the misrepresentation and that the misrepresentation is related to plaintiff's loss. In the case of a nondisclosure, causation may be established merely by proving the materiality of the omitted fact, which creates the presumption of reliance.[4] *Affiliated Ute Citizens v. United States*, 406 U.S. at 154; *Stromfield v. Great Atlantic & Pacific Tea Co.*, 484 F.Supp. 1264, 1270 (S.D. N.Y. 1980); *Eriksson v. Galvin*, 484 F.Supp. 1108, 1126 (S.D.N.Y. 1080). These rules should not be applied rigidly, but must always be used to analyze a particular set of facts with an awareness of the linkage between these concepts.

Some courts attempt to split causation into "loss causation" and "transaction causation." This distinction ap-

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[3]The linkage between materiality and reliance also supports this rule. Reliance on an immaterial fact is highly unlikely. The odds are, however, that an investor will rely on any material facts in making his investment decision.

[4]It is unclear why courts do not mention the need for some further proof of causation in omission cases. Perhaps it is believed that once materialitty is shown and reliance presumed. it is highly likely that causation is also present. In any event, defendants can always introduce evidence designed to undercut the causal connection between the fraud and loss.

pears to be based on confusion over whether a plaintiff should have to show that the alleged fraud was directly related to the security's drop in value (loss causation) or whether it is enough to show that the fraud induced purchase of the security (transaction causation). It might be argued that even when a defendant's fraud causes purchase of a security, it is unfair to find him liable when the loss is caused by factors unrelated to the fraud. The opposing argument is that any time fraud induces purchase, causation-in-fact or but-for causation of a resulting loss has been established.

It appears to the Court that the appropriate focus is on loss causation. *See Vervaecke v. Chiles, Heider & Co.*, 578 F.2d at 715. The essence of securities fraud *damage* actions is whether plaintiff suffered a loss because of the defendant's conduct, not whether he purchased a security because of it.[5] It also seems reasonable, however, to presume that a drop in value is caused by the fraud. *See Seiffer v. Topsy's International, Inc.*, 487 F.Supp. 643, 665-66 (D. Kan. 1980). Therefore, generally even if only transaction causation were established, plaintiff would have met his burden of proof on the causation issue; and any time loss causation is shown, even if transaction causation is not, that burden is met. *See Garnatz v. Stifel, Nicolaus & Co.*, 559 F.2d 1357, 1361 (8th Cir. 1977), *cert. denied*, 435 U.S 951 (1978). In this case there was sufficient evidence to sustain findings of both transaction and loss causation, and there is no basis for overturning the jury's conclusion that defendants' fraud led to plaintiffs' damages.

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[5]Of course, the fraud must be "in connection with" a sale or purchase for plaintiff to have standing. This is analytically different, however, from the determination whether the fraud induced the sale or purchase.

The law in the fraud area is not always crystal clear. The important thing is that the jury get an adequate statement of the law. The Court believes that its instructions were correct and fulfilled their purpose. Counsel were given wide latitude in arguing their theories of the case. The jury was attentive and apparently had a good grasp of the law and facts. Materiality, reliance and causation involve factual and objective determinations and are properly given to the jury for decision. No adequate reason has been presented to the Court for overturning the jury's findings. Not only was there ample affirmative evidence offered by plaintiffs to support the verdict, but defendant Loftsgaarden's evasive and resistive testimony could have seriously undermined the credibility of his version of the facts in the jury's eyes. Certainly the Court has no feeling that an injustice has been done to the defendants.

Defendants next raise a large group of interconnected arguments centering around the measure of damages and the tax benefits plaintiffs received on their investments. They claim that plaintiffs suffered no damage because of these tax benefits, that the Court used the wrong measure of damages, that the Court should have allowed the jury to decide when the fraud was discovered for damages purposes, that reference to tax benefits should not have been excised from some exhibits and that the Court should have received more evidence on subsequent events for the purpose of showing that plaintiffs' damages were their own fault. The Court finds no merit in any of these alleged errors.

Initially, the Court would note that defendants overstress the tax aspect of these investments. The offering memorandum contained projections which estimated large tax losses only in the first two years of the hotel's operation.

After two more years of small losses, the limited partners would have received significant yearly income on which tax would have to be paid. Each limited partner would have ended up with a large amount of tax owing, not including any tax on money received if and when the hotel was sold. In addition, the offering memorandum warned of impending changes in the tax laws which would limit the tax losses. Furthermore, plaintiffs were not actually going to make any money because of tax losses; what they were getting was a tax deferral. The limited partners clearly were interested in making money. The projections displayed a business which would provide them with good yearly income as well as gain at time of disposal. They were upset when they discovered that the project was becoming insolvent, and they took several steps to try to put the partnership on a profitable track, including loaning money and replacing the general partner. This suit is further evidence that plaintiffs do not feel they got their money's worth from some incidental tax benefits.

The Court did allow defendants to introduce evidence of the tax benefits to show that any misrepresentation on another subject was not material to the investors. The jury apparently rejected this argument and adopted the common sense view that people do not make an investment for losses, tax or otherwise, but because they anticipate a profit.

The Court totally rejects defendants' suggestion that because plaintiffs received some tax benefits they have not been damaged. Plaintiffs expended at least $35,000 each for a security which became worthless. The causes of the failure of the partnership business were linked to defendants' fraud. Plaintiffs have shown damage.

The subsequent events evidence which defendants sought to introduce, and the Court rejected, supposedly went to the merits of the counterclaim which was dismissed. Defendants did not represent at that time that it was being offered for any other purpose. Evidence was received from both sides on the ultimate fate of the hotel property. Any further evidence would have been repetitious and time consuming.

Damages in a 10b-5 action are intended to be compensatory. *Shapiro v. Midwest Rubber Reclaiming Co.*, No. 79-1424, slip op. at 10 (8th Cir. July 25, 1980); *Harris v. American Investment Co.*, 523 F.2d 220, 225 n.4 (8th Cir. 1975) *cert. denied*, 423 U.S. 1054 (1976). Generally, an "out-of-pocket" measure is used, *Harris v. American Investment Co.*, 523 F.2d at 225, but this is not a rigid rule and the Court must choose a measure of damages which will compensate plaintiffs. *See Nye v. Blythe Eastman Dillon & Co.*, 588 F.2d 1189, 1198 (8th Cir. 1978); *Garnatz v. Stifel, Nicolaus & Co.*, 559 F.2d at 1360. A rescissionary measure may be appropriate, particularly with securities that are worthless or have no objective standards by which they may be valued. *Garnatz v. Stifel, Nicolaus & Co., supra.*

In this case, however, an out-of-pocket or a rescissionary measure would yield the same results. The out-of-pocket formulation is usually the difference in value between purchase date and the time the fraud is discovered. *Shapiro v. Midwest Rubber Reclaiming Co., supra; Harris v. American Investment Co.*, 523 F.2d at 226. The fraud was or should have been discovered in August-September 1975. Defendants offered no reliable evidence to show that the date of discovery was any earlier. By this time the

partnership was essentially insolvent and the securities worthless. In fact, the securities had been worthless since early 1975. There was never any secondary market in which these units had value. Plaintiffs represented that they were purchasing their interests solely for investment, and the limited partnership agreement placed heavy restrictions on the resale of the units. Under these circumstances, the Court felt that if fraud had been committed, the only proper compensatory measure of damages was the refund of plaintiffs' purchase price. Even if this ruling were wrong as to the fraud claims, the Court's decision today that § 12(2) provides an alternative basis for defendants' liability supports the rescissionary measure of damages.

Defendants most vociferous argument is that plaintiffs' damages should have been offset by tax benefits received. This is sophistic malarkey. The best answer to defendants' contentions is found in decisions by well respected Federal courts. *Cooper v. Hallgarten & Co.*, 34 F.R.D. 482, 485-86 (S.D. N.Y. 1964). The court addressed the issue by saying:

> "The fact that the revenue laws permitted plaintiff to make deductions . . . has no bearing on the issue of whether plaintiff is entitled to receive the return of the amounts he paid. . . . If plaintiff should recover the sums he paid, they no doubt would be subject to appropriate tax treatment in his tax return as against the deductions and depletions and allowances taken in the earlier years."

The court in *Wiesenberger v. W. E. Hutton & Co.*, 35 F.R. 556, 558 (S.D. N.Y. 1964), stated that this argument was without merit. The court added that personal injury cases, where *loss of earnings* is at issue, should be distinguished.

Finally, the court noted that it was illogical to reduce damages for extraneous reasons wholly unconnected with defendant's wrongful conduct. Our own district court has rejected defendants' arguments in *Rhode v. Hershberger Explorations,* 349 F.Supp. 993, 994 (D. Minn. 1972). Judge Neville found the argument "fallacious," "circuitous" and "obviously without merit." The court stated that:

> "To the extent recovery is had, amended income tax returns will have to be filed to counteract the loss in the year deducted or in some way the recovery included in a current tax return as ordinary income."

See also Sharp v. Coopers & Lybrand, 83 F.R.D. 343 (E.D. Pa. 1979).

These decisions provide ample grounds for ignoring defendants' claims. *Bridgen v. Scott,* 456 F.Supp. 1048 (S.D. Tex. 1978), seems to be a case where the court's reasoning was tailored in an attempt to fit what it felt was a just result. There are also important factual distinctions, such as the fact that the investors were not to get a yearly income stream from the project.

Plaintiffs have lost the purchase price of their investment. They may have received some temporary tax savings. In the absence of defendants' fraud, they would ultimately have had significant income and tax costs. Plaintiffs, however, cannot recover the projected future income which they never received because the fraud measure of damages is strictly compensatory. Defendants' argument is a sort of reverse expectancy measure of damages and must be likewise rejected. Absent defendants' fraud, which induced their purchases, plaintiffs would probably have made other

investments which provided temporary tax savings, but without the total loss of their investment.

Defendants allege that the Court erred in instructing the jury that the limited partnership interests were securities. It is well settled that such interests are securities. *See Goodman v. Epstein,* 582 F.2d 388, 409 (7th Cir. 1978), *cert. denied,* 440 U.S. 939 (1979). Defendants argue that whether or not the interests were securities should be judged at a time after the purchase of the interests; and that plaintiffs' conduct in this case was sufficient to deprive the limited partnership interests of their status as securities. Whether or not a particular investment is a security must be decided as of the date of sale. Securities fraud laws are designed to prevent wrongdoing in connection with the *purchase or sale* of securities. It is patently unfair to deprive investors of the protection of the securities laws at the time they purchased the security merely because their subsequent conduct might change the classification of their investment. Such subsequent conduct might be a factor in determining whether a defendant's fraud caused plaintiff's loss, but it does not affect the nature of the investment at the time it was sold.

Defendants do not even attempt to argue that these limited partnerships were not securities when purchased. It is absolutely clear that plaintiffs, as limited partnership law requires, were to have no part in the day-to-day management of the partnership. Furthermore, the actions of the limited partners did not remove their investments from security status. They had the right to replace the general partner. They had the right to be concerned about what was happening to their investment, and to seek information to satisfy themselves that it was being properly

run. There was absolutely no evidence which showed that any limited partner, and, in particular, these plaintiffs, ever made any decisions relating to the daily management of the partnership business.

The Court allegedly erred in admitting evidence about a prior fraud committed by Loftsgaarden. He was found liable in 1976 of defrauding a person in connection with a real estate investment. Defendants argue that this could have nothing to do with his state of mind in 1973 when the plaintiffs' limited partnership units were sold. Defendants conveniently ignore the fact that although the verdict was returned against Loftsgaarden in 1976, the underlying circumstances of the fraud occurred before the sale of the limited partnership units at issue here. The evidence was probative of his intent, and the Court concluded that any prejudice caused by the evidence was outweighed by its usefulness. *See McCormick on Evidence* § 164.

Defendants again raise the issue of a prior settlement in another suit which supposedly bars this action. The Court has dealt with this claim in other orders and has nothing to add to those discussions. Defendants also claim that on the first day of trial the Court made certain prejudicial comments which required a mistrial. There is no substance to this claim either.

The parties had a fair trial before a competent jury. They were represented by able counsel. Another trial would not produce a substantially different result.

PLAINTIFFS' MOTION FOR JUDGMENT NOTWITHSTANDING THE VERDICT

Plaintiffs have moved for judgment notwithstanding the verdict against defendants Coult and Noah, who were di-

rectors of Alotel, Inc. Their liability would be based on "controlling person" and "aider and abettor" theories. The jury rejected these theories. The Court believes the jury's finding was proper. There was no evidence to show that these defendants had any awareness of any wrongdoing, or more than a minimal involvement in the entire hotel project. Neither defendant took any active part in or had any control over the management of Alotel, Inc. In fact, they appeared to have merely allowed their names to be used to fill the statutory quota of directors as a favor to Loftsgaarden. Even if the Minnesota law is broader than Federal law, the Court does not believe it would be just or correct under that law to impose liability on these defendants.

Plaintiffs also have moved for judgment NOV on the loans which the limited partners made to the partnership beginning in the spring of 1975. The jury found against plaintiffs on these loans, apparently because there was no reliance on any misrepresentations at the time the loans were made. The Court believes there was evidence to support the jury's findings, and that the jury's decision was correct. First of all, the loans probably cannot be viewed as securities or as a new investment decision based on prior purchase of a security. There was no clause in the limited partnership agreement requiring the limited partners to make additional capital contributions or loans. *Cf. Goodman v. Epstein*, 582 F.2d 388, 391 n 8, 414 (7th Cir. 1978), *cert. denied*, 440 U.S. 939 (1979). The loans may or may not be securities themselves; the Court feels they are not. Whether they are or not, there was evidence from which the jury could have inferred that there was no reliance on any fraud by defendants when plaintiffs made the

loans. Even if there were additional omissions, on which reliance would not have to be shown, plaintiffs would still have to establish causation. There was clear and ample evidence from which the jury could have found that plaintiffs made the additional loans because they were advised that if they did not do so, the whole venture would go bankrupt, and that defendants' fraud had no role in the decisions to make the loans to the partnership. The Court today has also found that the § 12(2) claims do not provide a basis for liability on the loans because no causal relation existed between defendants' fraud and the extension of the loans.

PLAINTIFFS' MOTION FOR PREJUDGMENT INTEREST AND COSTS

Plaintiffs have requested that the judgment be amended to include prejudgment interest. If the 10b-5 claims were the only source of defendants' liability, the Court would deny this request. *See Nelson v. Hench,* 428 F.Supp. 411, 421 (D. Minn. 1977). In a separate opinion issued today, however, the Court has accepted the jury's advisory verdict on the § 12(2) claim. That section, 15 U.S.C. § 77*l* (2), allows prejudgment interest. Plaintiffs contend that 28 U.S.C. § 1261 requires that the Court look to State law to find the applicable rate of interest. They say that rate is provided by Minn. Stat. § 549.09. Neither of those statutes applies to prejudgment interest. The Court believes that the traditional 8% interest rate is a fair rate to apply here.

In addition, Minn. Stat. § 80A.23 subd. 2, which the jury also found to be a basis for plaintiffs' recovery, allows prejudgment interest. Not all of the plaintiffs, however, could claim the benefit of this provision, because it had

an August 1, 1973, effective date. If the § 12(2) finding is reversed, only plaintiff Randall and plaintiff Neumann would be entitled to prejudgment interest.

Plaintiffs have also requested an award of costs. The figure presented by plaintiffs appear to be reasonable and this amount will be granted.

PLAINTIFFS' MOTION FOR ATTORNEYS' FEES

Plaintiffs have moved the Court to allow the recovery of attorneys' fees. The Federal securities law claims do not support the granting of attorneys' fees. Minn. Stat. § 80.23 does allow attorneys' fees, but, as noted above, this section is not applicable to all the plaintiffs' claim. A transitional section to the new securities law provided that the old law, which did not allow attorneys' fees, would govern cases "initiated on the basis of facts or circumstances occurring before August 1, 1973 " Plaintiffs Austin and Anderson purchased their interests in the limited partnership before August 1, 1973. The facts and circumstances which form the basis of their claims would be the alleged fraud which took place when they were sold these interests. These misstatements and omissions occurred before the applicable date of the new securities law. Only plaintiffs Randall and Neumann can recover their attorneys' fees.

Randall's attorneys submitted an affidavit totaling about $31,000 in fees, without multiplier. The Court does not believe this would be a reasonable fee to award. No division of time was made between fees for the Minnesota law claims and the Federal claims. The elements of the two are similar, but there are also distinctions. The Court questions whether it was necessary for Randall to be rep-

resented by two attorneys at trial. Much of the work was probably duplicated by the other plaintiffs' attorneys. While each plaintiff is entitled to his own counsel, it is not fair to saddle a defendant with the excessive fees generated by this arrangement. A reasonable fee for Randall's attorneys is $10,000.

Neumann shared attorneys with Austin and Anderson. They had an agreement whereby each would pay one third of the total billing. It is likely, however, that most of the work done by these plaintiffs' attorneys would have been done even if Neumann had been the only client. The problems presented by the fee requested by Randall's attorneys are a factor here also. Neumann's attorney, however, did most of the trial work. A fee of about $34,000 was requested. It appears to the Court that a reasonable fee would be $15,000.

Therefore, IT IS ORDERED THAT:

1. Defendants' motions for Judgment Notwithstanding the Verdict or a New Trial are denied.

2. Plaintiffs' motion for Judgment Notwithstanding the Verdict is denied.

3. Plaintiffs' motions for prejudgment interest are granted in the following amounts, computed at 8% per annum from the date of purchase:

Plaintiff Randall:	$18,924.59
Plaintiff Anderson:	20,175.25
Plaintiff Austin:	19,991.17
Plaintiff Neumann's ½ unit	9,556.66
Plaintiff Neumann's one unit	19,553.53

4. Plaintiffs' motions for costs are granted in the following amounts:

Plaintiff Randall	$1,308.62
Plaintiffs Anderson, Austin and Neumann:	2,210.53

5. Plaintiffs Randall and Neumann's motions for an award of attorneys' fees are granted as follows:

Plaintiff Randall:	$10,000.00
Plaintiff Neumann:	15,000.00

Plaintiffs Austin and Anderson's motions for attorneys' fees are denied.

August 15, 1980.

/s/ Earl R. Larson
United States Senior District Judge

APPENDIX G

STATUTES AND REGULATION

Section 12(2) of the Securities Act of 1933, 15 U.S.C. §77*l*(2):

> Any person who —
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> * * *
>
> (2) offers or sells a security . . . by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,
>
> shall be liable to the person purchasing such security from him who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b):

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails or of any facility of any national security exchange —

> (b) To use or employ in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. § 240.10b-5:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national security exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit on any person, in connection with the purchase or sale of any security.

Section 28(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78bb(a):

> The rights and remedies provided by [the Securities Exchange Act of 1934] shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of the actual damages on account of the act complained of.

Supreme Court, U.S.
FILED
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CLERK

(3)

No. 85-519

IN THE

Supreme Court of the United States

October Term, 1985

DR. WILLIAM C. RANDALL, DR. ROGER E. AUSTIN, DR. TOM W. ANDERSON and DR. MYREL A. NEUMANN,

Petitioners,

v.

B. J. LOFTSGAARDEN; ALOTEL INCORPORATED, a Minnesota corporation; PROPERTY DEVELOPMENT AND RESEARCH COMPANY, a Minnesota corporation; and 2361 BUILDING CORPORATION, a Minnesota corporation,

Respondents.

RESPONDENT'S BRIEF IN OPPOSITION

B. J. Loftsgaarden
1965 Bayard Avenue
St. Paul, Minnesota 55116
Telephone: (612) 698-5698
Attorney pro se

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REASONS FOR DENYING THE WRIT

1. Calculation of damages the only issue.

2. The fact issues make this case one of narrow application. All Petitioners had experienced complete recapture and had their tax returns audited and closed. These facts distinguish this case from the broad field of cases where questions of amended returns and "illusory damages" have arisen.

3. Actual out-of-pocket loss by the group of Petitioners is small, ($14,477.00) including interest, yet two trials and two appeals have resulted in award of $75,000.00 attorneys' fees to Petitioners' lawyers.

4. The decision of the Eighth Circuit Court with the respect to the calculation of damages is the appropriate remedy in this particular case.

5. There is no conflict between the decision of the Eighth Circuit and the Ninth Circuit or Second Circuit.

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IN THE

Supreme Court of the United States

October Term, 1985

No. 85-519

DR. WILLIAM C. RANDALL, DR. ROGER E. AUSTIN, DR. TOM W. ANDERSON and DR. MYREL A. NEUMANN,

Petitioners,

v.

B. J. LOFTSGAARDEN; ALOTEL INCORPORATED, a Minnesota corporation; PROPERTY DEVELOPMENT AND RESEARCH COMPANY, a Minnesota corporation; and 2361 BUILDING CORPORATION, a Minnesota corporation,

Respondents.

RESPONDENT'S BRIEF IN OPPOSITION

Respondent respectfully prays that a writ of certiorari to review the en banc judgment and opinion of the United States Court of Appeals for the Eighth Circuit entered in this proceeding on July 16, 1985 be denied.

STATEMENT OF THE CASE: ADDITIONAL FACTS

All of Petitioners' investments went to Alotel Associates, a Limited Partnership whose sole asset was a single motel including all furnishings. Alotel Associates is not a party to these proceedings. No proof was offered to support any assertions that the Respondent profited. The project came

up short on needed construction capital but was completed by Respondent at his expense.

The four Petitioners all purchased their 4½ partnership interest sometime in 1973 and held them through final foreclosure of the project in 1978. Holders of the rest of the 20½ units did not pursue any claim, although all were named as original parties. They, like Petitioners, had recovered substantially all or more than all of their investment through the promised tax benefits. The Petitioners received tax benefits from the project in each of the years from 1973 thru 1978 and paid their full taxes arising out of recapture when the property was foreclosed. The Petitioners have stipulated and the Court has found that even after payment of recapture taxes, Petitioners have retained permanent net tax benefits equal to between 84% and 108% of their investment. Full audits have been made and closed by the I.R.S. Calculations from the Petitioners' tax returns made by a C.P.A. and adopted by the Court show only a combined net $1,134.00 not so recovered, and interest on these amounts to be $13,339.00 (all four awards combined). The total balance in the amount of $14,477.00 was doubled to grant the Petitioners an additional amount (assuming they are in the 50% bracket still) to allow for taxes that would accrue on this additional recovery. Appendix A-22.

No tender of any of the securities nor any rescissionary demands were made by any of the Petitioners at any time prior to the foreclosure, and in fact, rescission was not demanded until shortly before the first trial when the Petitioners amended their claim for relief. At that time, and ever since, the Petitioners have had nothing to return in exchange for their claimed refund, as all of the property in the part-

nership had been foreclosed and the time for redemption had expired.

Respondent Loftsgaarden was General Partner until September 1975, the hotel having opened in June 1974. A mutual separation agreement was entered into and a successor General Partner was appointed by the limited partners. Loftsgaarden received nothing for his services, as compensation depended upon profits. Furthermore, he was not reimbursed for substantial monies advanced in behalf of the partnership. The partnership operated the property until sometime in 1978 without Respondent.

In accordance with the Offering Memorandum, each of the limited partners were required to sign a document certifying as follows:

a. He is aware that no federal or state agency has made any findings or determination as to the fairness for public investment, nor any recommendation nor endorsement of Units;

b. He recognizes that the Partnership has only recently been organized and has no financial or operating history and, further, that the Units as an investment involve a high degree of risk;

c. He is aware that there is no public market for Units and that it may not be possible readily to liquidate his investment;

d. He understands that the Units have not been registered with the Securities and Exchange Commission or under the securities laws of any state. The Units are being acquired for investment purposes and not for purposes of resale or other distribution.

e. He has carefully reviewed the Articles and, in making an investment in the Partnership, has relied solely thereon and on his independent investigation.

f. He has a net worth in excess of $200,000; or some portion of his income is subject to Federal and State income tax at a rate of 50% or more.

g. He is a resident of the State of Minnesota.

All of the named corporate Defendants are subchapter "s" corporations, wholly owned by Loftsgaarden, who was also the sole individual General Partner. For these reasons, the Defendants will be referred to herein as "Respondent" or "Loftsgaarden".

REASONS FOR DENYING THE WRIT

1. Calculation of Damages the Only Issue.

Respondent does not request review by the Supreme Court of the United States. The questions presented by the Petitioners relate only to damage calculations. Referring only to cases cited in the Circuit Court of Appeals opinion, the following were all the subject of Petition for Certiorari, which was denied:

Globus v. Law Research Serv., Inc., 418 F.2d 1276 (2d Cir.), *cert. denied*, 397 U.S. 913 (1970);

Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38 (2d Cir.), *cert denied*, 439 U.S. 1039 (1978);

Murphy v. Cady, 30 F. Supp. 466 (D. Me. 1939), *aff'd*, 113 F.2d 988 (1st Cir.), *cert denied*, 311 U.S. 705 (1949);

Shapiro v. Midwest Rubber Reclaiming Co., 626 F.2d 63 (8th Cir. 1980), *cert. denied*, 449 U.S. 1079 (1981); cf. 15 U.S.C. § 78BB (a);

Harris v. American Investment Co., 523 F.2d 220 (8th Cir. 1975), *cert. denied*, 423 U.S. 1054 (1976);

Garratz v. Stifel, Nicolaus & Co., 559 F.2d 1357 (8th Cir. 1977), *cert. denied*, 435 U.S. 951 (1978);
Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

The following cases from the Petitioners' brief resulted in a denial of Certiorari:

John Hopkins Univ. v. Hutton, 297 F. Supp. 1165 (D. Md. 1968), *rev'd on other grounds*, 422 F.2d 1124 (4th Cir. 1970), *cert. denied*, 416 U.S. 916 (1974);
Janigan v. Taylor, 344 F.2d 781 (1st Cor.), *cert. denied*, 382 U.S. 879 (1965).

The instant case, while of significance to the litigants, just does not produce any issues of general interest beyond Court of Appeals level. The parties have been afforded ample review.

2. Narrow Application.

The instant case involves facts which narrow and limit the issue with respect to the deductibility of tax benefits from the award. All of the Petitioners held an interest in a partnership that lasted from sometime in 1973 through 1978 (in the case of one of the Petitioners 1979), at which time the property was foreclosed and the Petitioners experienced a complete recapture. Out of a total of 25 limited partnership units issued, only holders of 4½ units chose to pursue litigation. The others recognized that they had, in fact, gained substantial benefits despite the foreclosure. In *Austin v. Loftsgaarden*, 786 F.2d 949 (8th Cir. July 16, 1985), the Tax Division and the S.E.C. contended that the plaintiffs' tax benefits "may" prove to be illusory because

they "may" experience recapture upon sale or other disposition of the hotel. The Court said at Appendix A-11:

> "The plaintiffs claim that their tax benefits have not been received must also be rejected because they have stipulated that *they have received permanent tax benefits* from the investments in the Associates. (emphasis ours). . . . All of the plaintiffs in this case have already experienced all possible recapture when the hotel was foreclosed upon in 1978. . . . All of the plaintiffs' tax returns from the relevant tax years have already been audited and are now closed".

Thus the ruling in the instant case is limited to the narrow fact situation described above. The review of this case would not address the broader issues addressed by the two principal cases upon which the Petitioners rely: *Burgess v. Premier Corp.*, 727 F.2d 826, and *Western Federal Corp v. Erickson*, 739 F.2d 1439 (9th Cir. 1984). These are distinguished from the present case because in those cases it was held that amended returns would have to be filed under the tax benefit rule.

3. Actual Damages Small; Costs High.

Respondent has been ordered to pay to Petitioners' attorneys for four different proceedings, two in the lower court and two at the appellate level, a total of $75,000.00 plus costs in the amount of $8,278.32 making the total $83,278.32. The breakdown of fees and costs awarded is as follows:

	FEES RANDALL	FEES NEUMANN	COSTS RANDALL	COSTS ANDERSON, AUSTIN, NEUMANN
1st Trial	$10,000.00	$15,000.00	$1,308.62	$2,210.53
1st Appeal		$18,000.00		
2nd Trial	$10,000.00	$14,000.00		$3,111.30
2nd Appeal	$ 4,000.00	$4, 000.00	$1,647.87	
TOTAL FEES		$75,000.00	TOTAL COSTS	$8,278.32

This is in addition to the extensive legal fees already incurred by Respondent for its own attorneys. As against the foregoing figures, the actual damages of the four Petitioners is as follows:

Randall award	$ 253.00
Anderson award	$ 9,395.00
Neumann award	$ 992.00
Austin award	$ 3,833.00
TOTAL AWARD	$14,473.00

(Of the above amounts, $13,339.00 is interest). Appendix A-22.

Respondent submits that the proceedings have involved time and expense way beyond the amount of attention and time that should have been devoted to settling the same. As Judge Lord said in his order,

> "plaintiff Randall is struggling to further protract and complicate a *proceedings that has already dragged on far too long*. That will not be tolerated by this Court." (Emphasis ours). Appendix C-3.

The projected profit referred to in the prospectus never materialized. Loftsgaarden did not profit in any way from the venture. Instead, as General Partner, he paid extensive obligations of the partnership, including $46,000.00 unpaid interest after the partnership defaulted.

Respondent states to the court that he cannot continue to defend these proceedings, paying legal counsel on both sides. He has thus determined to proceed at this point Pro Se. Respondent suggests to the court that there is an additional inducement to prolonging and continuing the proceedings if attorneys' fees in substantial amounts are awarded at each juncture.

This case may well have come to rest before this point but for the incentive on the part of Petitioners' counsel to continue the litigation. Respondent is now in the process of paying the amounts adjudged against him, including all costs and attorneys' fees. This should end this over-protracted litigation.

Plaintiffs have lamented about the unjust "profit" they claim was retained by Respondent. The evidence and findings do not support this argument. The only finding about profit relates to a discrepancy between the schedule of projected application of funds in the offering memorandum and a projection in the first mortgage application. Appendix E-7 (o).

In *Austin v. Loftsgaarden* (2nd decision supra) the Court said:

> "We reject plaintiffs claim that we should ignore their tax benefits because otherwise the defendants will unjustly "retain" the consideration previously paid by the plaintiffs. First of all, it does not appear that the defendant has "retained" any of plaintiffs consideration; rather these monies were paid to the partnership and were invested in the project". Appendix A-13.

Respondent has incurred great losses both in the original partnership and in the defense of this action. Petitioners' counsel continue to argue the opposite without any factual support.

4. The Court of Appeals Ruling Was Correct.

Petitioners rely on *Western Fed. Corp. v. Erickson*, 739 F.2d 1439 (9th Cir. 1984), and *Burgess v. Premier Corp.*, 727 F.2d 826 (9th Cir. 1984), in which cases the Court discussed the damages being "illusory" and held that the tax consequences will "wash out" any prior tax savings.

In *Austin v. Loftsgaarden* (2nd decision supra), the Court clearly distinguished these cases as follows:

> "We need not address the contention of the Tax Division and the S.E.C. that the tax consequences of the rescissionary award will 'wash out' any prior tax savings, because we are not presented with such a situation in this case". Appendix A-12.

In making this distinction in *Austin v. Loftsgaarden* (2nd decision 1985 supra), the Court relied upon *Hillsboro National Bank v. Commissioner,* 460 U.S. 370, 103 S.Ct. 1134, 75 L.Ed.2d 130, 142-44 (1983); *Salcer v. Envicon Equities Corp.,* 744 F.2d at 943; 1 Mertens, Law of Federal Income Taxation, #7.34 at 7-115, #7.37 at 7-130.

In *Austin v. Loftsgaarden* (2nd decision 1985 supra), the Court went on to say at Appendix A-12:

> "The 'tax benefit rule' does not require elimination of tax benefits already received. See Hayden v. McDonald, 742 F.2d 440. Rather it provides that a tax payer who claims a deduction resulting in a tax benefit one year and who later obtains a recovery or repayment in a later year must include the recovery or repayment as ordinary income in the year of recovery". (*Hayden v. McDonald,* reversed in part).

Especially important is the distinguishing feature between the instant case and the *Burgess* case in that the *Burgess* case involved a fraudulent tax shelter. The only questions raised in *Austin v. Loftsgaarden* was with the respect to the issuing of the Offering Memorandum; it was conceded by all that the tax shelter was in itself entirely lawful and that the Government has audited all returns and accepted the same.

Austin v. Loftsgaarden (2nd decision 1985 supra), relies on *Salcer v. Envicon Equities Corp.*, 744 F.2d at 943:

> "Nor can we agree with the notion that a ruling makes 'the Government the banker for fraudulent tax shelter activity.' Burgess v. Premium Corp., supra, 727 F.2d 838. As Judge Broderick noted there was no such activity in this case; the fraud, if any, pertained only to the investment aspects of the Greenspoint Project. The Government got the residential development that it hoped to encourage by offering the tax benefits taken by the plaintiffs. Thus it is 'banking' precisely what it agreed to 'bank'. There is suggestion that the project did not meet Federal requirements as a viable housing development entitling its owners to tax benefits".
>
> "There is no legal justification for awarding a party damages to which he is not entitled merely to provide revenue for the Government to tax". Appendix A-14.

In answer to the Petitioners' argument that the words "actual damages" do not appear in the 1933 Act, the Court in *Austin v. Loftsgaarden* (2nd decision) says:

> "Although the words 'actual damages' do not appear in the 1933 Act, the Courts have nonetheless applied the actual damages principle of section 28(a) to bar punitive damages under section 17(a) of the 1922 Act, Globus v. Law Research Serv., Inc., 418 F.2d 1276, 1278, 1283-86 (2d Cir.), cert. denied, 397 U.S. 913 (1970), and have construed the rescission and restitution remedy provided by section 12 (2) as substantially equivalent to the damages permitted under section 28(a). Affiliated Ute Citizens v. United States, 406 U.S. 128, 155 (1972). The goal of rescission under section 12 (2) is to return the parties to the status quo ante, 'and hence a plaintiff can recover no more

than his or her "net economic loss",' i.e., 'actual damages' ". *Salcer,* 744 F.2d at 940; *Austin I,* 675 F.2d at 181; *Rolf v. Blyth, Eastman Dillon & Co., 570* F.2d 38, 49 n.22 (2d Cir.), *cert. denied,* 439 U.S. 1039 (1978). Appendix A-8, A-9.

In regard to tax benefits received and "actual damages" see *Salcer v. Envicon Equities Corp.,* 744 F.2d 935, 940 (2d Cir. 1985):

" 'Actional damages', as used in the Exchange Act, means 'compensatory damages,' *id.* and hence a plaintiff cannot recover more than his or her 'net economic loss.' Marbury Management, Inc. v. Kohn, 470 F. Supp. 509, 516 (S.D.N.Y. 1979), aff'd in part, rev'd in part, 629 F.2d 705 (2d Cir.), cert. denied, 449 U.S. 1011, 101 S.Ct. 566, 66 L.Ed.2d 469 (1980). It is not within our power to ignore benefits bargained for and received by plaintiffs as a result of the transaction at issue, which represent real economic value mitigating any loss they may have suffered."

"The importance of this aspect of the investment is recognized in decisions awarding damages for failure of the tax advantages of shelters to live up to the seller's representations. See, e.g., Sharp v. Coopers & Lybrand, 649 F.2d 175 (3d Cir. 1981) (holding accounting firm liable for acts of employee in preparing tax opinion letter), cert. denied, 455 U.S. 938, 102 S.Ct. 1427, 71 L.Ed.2d 648 (1982)."

*Austin v. Loftsgaarden (*1985) 2nd decision:

"The goal of prejudgment interest is to compensate plaintiffs for the loss of the use of their money. See Cant v. A. C. Becker & Co., 384 F. Supp. 814 (N.D. Ill. 1974); Chris-Craft Industries, Inc. v. Piper Aircrafter Corp., 384 F. Supp. 507, 527 (S.D.N.Y. 1974), modified, 516 F.2d 172 (2d Cir. 1975), rev'd on other

grounds, 430 U.S. 1 (1977). Because plaintiffs were not deprived of the use of the entire amount of their investments over the ten year period, prejudgment interest is due only on the amount of money they were out-of-pocket at any given time. Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1307 (2d Cir. 1973) (prejudgment interest should be computed on the "net difference between value of assets given and value received"). Murphy v. Cady, 30 F. Supp. 466, 470 (D. Me. 1939), aff'd, 113 F.2d 988 (1st Cir.), cert. denied, 311 U.S. 705 (1940). Appendix A-19, A-20.

Cases cited by Petitioners that support Respondent:

Smith v. Bader, 83 F.R.D. 437;
Bridgen v. Scott, 456 F. Supp. 1048 (S.D. Tex. 1975);
Houlihan v. Anderson-Stokes, 78 F.R.D. 232 (1978);
Hokama v. B. F. Hutton & Co., Inc., 566 F.2d 836 (1983).

Cases cited by Petitioners that are not security cases and therefore do not involve a tax shelter security produced and marketed by a defendant:

Iowa-Des Moines National Bank v. Schwerman, 288 N.W.2d 198;
Harris v. Metropolitan Mall, 334 N.W.2d 519 (Wisc. 1983);
G. & R. Corp. v. American Sec. Trust Co., 523 F.2d 1164 (C.D. Cir. 1975);
Cereal Bi-products Co. v. Hall, 16 Ill. App.2d 81, 147 F.2d 383.

The following cases cited by Petitioners are distinguished in their fact situation in that they do not present facts involving foreclosure, recapture, and previously paid taxes:

Eisenberg v. Gagnon, 766 F.2d 770 (1985);
Borovoy v. Burser Realty Corp., 86 Mich. App. 732, 273 N.W.2d 545 (1979);
Spatz v. Borenstein, 513 F. Supp. 571 (N.D. Ill. 1981).

5. There Is No Conflict Between the Decision of the Eighth Circuit and the Ninth Circuit or Second Circuit.

Petititoner urges that the Court consider this issue to resolve conflicts between Circuits.

The real distinction between *Burgess* and *Austin* is found in *Burgess* itself where *Burgess* considered the *Austin* case and distinguished it. The Court said that the plaintiffs in the *Burgess* case were presumed to be required to amend original returns and therefore a full recovery was required to put them back into their original situation. The opposite is true in the *Austin v. Loftsgaarden* case where the plaintiffs have paid their taxes on the entire amount they have received as recapture on foreclosure. Therefore neither the *Burgess* nor *Western* cases are in conflict but are distinguished by the fact situation.

The history concerning the Second Circuit's addressing the tax benefit question is described in *Salcer v. Envicon Equities Corp.*, 744 F.2d 935 (2d Cir. 1984) at 939:

> "We have never addressed a question of whether in an action alleging fraud with the respect to a tax shelter investment, the plaintiffs recovery must be reduced by tax benefits received."

We find that two years earlier in the case relied upon by Petitioners, *Western Fed. Corp. v. Davis,* 553 F. Supp. 818 (1982), the following:

> "While the statute mentions only 'income' as a credit against the amount paid, courts have held that economic benefits such as tax deductions must be taken into account in determining what must be restored. Austin v. Loftsgaarden, 675 F.2d 168, 181-83 (8th Cir. 1982). See also Dupuy v. Dupuy, 551 F.2d 1005 (5th Cir.), cert. denied, 434 U.S. 911, 98 S.Ct. 312, 54 L.Ed.2d 197 (1977); Smith v. Bader, 83 F.R.D. 437 (S.D.NY. 1979); Bridgen v. Scott, 456 F.Supp. 1048 (S.D.Tex. 1978)."

The 1979 case of *Smith v. Bader,* 83 F.R.D. 437 (S.D. N. Y. 1979):

> "The plaintiffs' investments in other partnerships and their investments in other tax shelters may shed light on their sophistication as investors. Similarly, knowledge of plaintiffs' income tax rate and the net value of their investment in the partnership, along with other information, may be needed to calculate any tax benefits which may mitigate damages. See Dupuy v. Dupuy, 551 F.2d 1005 (5th Cir. 1977), cert. denied, 434 U.S. 911, 98 S.Ct. 312, 54 L.Ed.2d 197 (1977); Bridgen v. Scott, 456 F.Supp. 1048, 1062 (S.D.Tex. 1978); Houlihan v. Anderson-Stokes, Inc., 78 F.R.D. 232, 234 n.1 (D.D.C. 1978)."
>
> "Accordingly, plaintiffs are to produce their tax returns for defendants' inspection within ten (10) days."

The above cases are more recent than the relatively early F.R.D. cases cited by Petitioners in the Second Circuit, *Cooper v. Hallgarten & Co.,* 34 F.R.D. 484, and *Wiesen-*

berger v. W. E. Hutton & Co., 35 F.R.D. 556, 557 (S.D. N.Y. 1964).

In *Bridgen v. Scott*, 456 F. Supp. 1048 (S.D.Tex. 1978), the Court said:

> "Recision calls for cancellation of the bargain, and the return of the parties to the *status quo ante;* where this is impossible because of the disposal or retirement of the stock, . . . what restitutional damages are to be awarded must depend upon the facts of the particular case."
>
> "In Garnatz v. Stifel, Nicolaus & Co., Inc., supra, at 1360, the Eighth Circuit said that the court's '. . . function is to fashion the remedy best suited to the harm.' The trial court in calculating damages not only may, but should, look to particular factors, unique in each case, in reaching that determination."
>
> "Requiring the jury or this Court to try this case without reference to the tax consequences of the transaction would be requiring the jury and the Court to live in an artificial 'never-never land.' The plaintiffs' position that the tax consequences of this transaction should be ignored is simply not realistic and is tantamount to requesting this Court and the jury to try this case blindfolded."

The *Western Fed. Corp. v. Erickson case* (supra) can be seen, then, to approve and support *Austin v. Loftsgaarden,* but the Court simply found that the facts were different; page 820:

> "The amounts claimed as a deduction and the amounts later reported as income will wash out and the net tax benefit will be nothing. In this case, the economic benefit by way of a tax deduction, therefore, is illusory.

Salcer v. Envicon Equities Corp. (supra), is not in conflict with *Western Fed. Corp. v. Erickson.* It simply found the facts to be similar to the *Austin v. Loftsgaarden* in that the benefits by way of tax deduction would not be washed out and would not be "illusory".

> "To the extent that plaintiffs invested in a tax shelter, all benefits they received from their investment, including tax benefits, would have to be deducted in calculating the rescissionary damages, if any, to which they would be entitled."
>
> "The contention that the tax benefit doctrine applies to this case suffers from some basic misconceptions. It fails to distinguish between actual rescission, which is impossible in this case because of the forced sale of the project, and rescissionary damages, which are not the same as rescission and may be awarded when actual rescission is unavailable."
>
> "In short, the 'tax benefit doctrine' does not dictate the district court's decision but depends for its applicability upon the substance of that decision. To hold as the government urges would put the cart before the horse."

As to the collateral source argument, it may appear that, on first blush, *Western Fed. Corp. v. Erickson* (supra) is in conflict with *Salcer v. Envicon Equities Corp.* (supra) in the *Federal Corp.* case at P. 821:

> "Rescission is an equitable remedy to return parties to their prior positions and to work fairness to them. It was not the defendants who gave the tax benefits to the plaintiffs. It was the Government. If the defendants were to be given a credit for the value of the use of the money, that credit would reduce the amount of income that the Government would recapture under the

> tax benefit rule. In effect, the reduction in the amount that the defendants would have to return would only be at the Government's expense."

Whereas in *Salcer v. Envicon Equities Corp* (supra), at p. 941:

> "The essence of the collateral source rule is the independence of the transaction giving rise to the collateral source, such as the insurance policy. Here, in contrast, the tax benefits, although paid by the government, emanate directly from the tax shelter sought by the plaintiffs and provided by defendants, without which plaintiffs could not have realized any tax benefits. Benefits resulting directly from a transaction under attack must be credited toward the damage award.
>
> "The fact that the tax benefits were paid by the government rather than by the defendants does not lessen the defendants' role in securing them. To hold otherwise would be to confer an undeserved windfall upon the plaintiffs."

A closer examination would reveal that the arguments are mutually consistent. In the *Western Fed. Corp.* case, the Court found that there had been no recapture and that therefore there would be a wash out and the plaintiffs would not have already paid taxes on the recapture. Therefore the rule in that case and in that situation is consistent with *Salcer v. Envicon Equities Corp.*, and with *Austin v. Loftsgaarden.*

Burgess v. Premier Corp. (supra), presented a fraudulent tax shelter situation affecting value. Neither *Burgess* nor *Western Fed.* involved a factual situation where it had been stipulated that a complete recapture, audit, and closed return had occurred.

The Second Circuit decision, *Salcer v. Envicon Equities Corp.*, is in accord wtih the instant case and relied upon by the Eighth Circuit. There is no conflict between these two Circuits.

The *Austin v. Loftsgaarden* decision applies only to cases in which tax shelter is a substantial factor in connection with investor goals. Out of $157,500.00 invested, all but $14,473.00 has been recovered after recapture (including $13,339.00 interest). The investment was a lawful one and the I.R.S. has audited all returns and they are closed. Appendix A-22.

Finally, the Petitioners were certainly made whole by reason of the doubling of the award.

CONCLUSION

For the foregoing reasons, a writ of certiorari should be denied.

Respectfully submitted,

/s/ B. J. Loftsgaarden
2540 No. Cleveland Avenue
St. Paul, Minnesota 55113
(612) 636-3743
Pro Se

Supreme Court, U.S.
FILED
JAN 6 1986
JOSEPH F. SPANIOL, JR.
CLERK

(5)

No. 85-519

In The

Supreme Court of the United States

October Term, 1985

DR. WILLIAM C. RANDALL, DR. ROGER E. AUSTIN, DR. TOM W. ANDERSON and DR. MYREL A. NEUMANN,

Petitioners,

v.

B. J. LOFTSGAARDEN; ALOTEL INCORPORATED, a Minnesota corporation; PROPERTY DEVELOPMENT AND RESEARCH COMPANY, a Minnesota corporation; and 2361 BUILDING CORPORATION, a Minnesota corporation,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

JOINT APPENDIX

Robert Arthur Brunig
O'CONNOR & HANNAN
3800 IDS Tower
80 South Eighth Street
Minneapolis, Minnesota 55402
Telephone: (612) 343-1200

Wilbur F. Dorn, Jr.
DORN LAW FIRM, LTD.
300 East Main Street
Suite 200
Anoka, Minnesota 55303
Telephone: (612) 427-5903

Counsel for Petitioners

John A. Grimstad
Ted S. Meikle
FREDRIKSON & BYRON, P.A.
1100 International Centre
Minneapolis, Minnesota 55402
Telephone: (612) 347-7000

Terence M. Fruth
FRUTH & ANTHONY, P.A.
1350 International Centre
Minneapolis, Minnesota 55402
Telephone: (612) 349-6969

John M. Friedman, Jr.
DEWEY, BALLENTINE, BUSHBY, PALMER & WOOD
1400 Broadway
New York, New York 10005
Telephone: (212) 820-1100

Counsel for Respondents

PETITION FOR CERTIORARI FILED SEPTEMBER 24, 1985
CERTIORARI GRANTED NOVEMBER 12, 1985

COCKLE LAW BRIEF PRINTING CO., (800) 835-7427 Ext. 333

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CHRONOLOGICAL LIST OF RELEVANT DOCKET ENTRIES

February 24, 1976 — Plaintiffs' Complaint filed in United States District Court for the District of Minnesota.

December 26, 1978 — Plaintiff Dr. William C. Randall's Amended and Separate Complaint filed.

May 18, 1979 — Plaintiffs' Dr. Myrel A. Neumann, Dr. Tom W. Anderson and Dr. Roger E. Austin's Amended Separate Complaint filed.

June 16, 1980 — Plaintiff Dr. William C. Randall's Fourth Amended and Separate Complaint filed.

June 16, 1980 — Defendants' Joint and Separate Answer to Plaintiff Dr. William C. Randall's Third Amended Separate Complaint filed.

June 16, 1980 — Defendants' Joint Separate Answer to Plaintiffs Roger E. Austin, Dr. Tom W. Anderson and Dr. Myrel A. Neumann's Second Amended Separate Complaint filed.

June 17, 1980 — Jury and court trial of action commenced.

June 24, 1980 — Court's charge to jury.

June 25, 1980 — Plaintiff Dr. Roger E. Austin, Dr. Tom W. Anderson and Dr. Myrel A. Neumann's Third Amended Complaint filed.

June 25, 1980 — Special verdict filed.

June 25, 1980 — Judgment of District Court entered, awarding Plaintiffs Dr. Roger E. Austin, Dr. Tom W. Anderson and Dr. William C. Randall each judgment in the sum of $35,000, plus costs, and awarding Plaintiff Dr. Myrel A. Neumann judgment in the sum of $52,500, plus costs.

July 7, 1980 — Defendants' Motion for Judgment Notwithstanding the Verdict or New Trial filed.

July 11, 1980 — Plaintiffs Dr. Roger E. Austin, Dr. Tom W. Anderson and Dr. Myrel A. Neumann's Motion for Prejudgment Interest, Attorney's Fees and Judgment on Section 12(2) Claims filed.

July 14, 1980 — Plaintiff Dr. William C. Randall's Motion for Supplemental Findings of Fact, Conclusions of Law and Amended Order for Judgment filed.

August 15, 1980 — Findings of Fact, Conclusions of Law and Order for Judgment filed.

August 15, 1980 — Memorandum Order entered, denying all Motions for Judgment Notwithstanding Verdict or for New Trial, awarding prejudgment interest, computed at 8% per annum from the dates of purchase, awarding costs, awarding attorney's fees to Plaintiffs William C. Randall, Dr. Myrel A. Neumann and denying attorney's fees to Plaintiffs Dr. Roger E. Austin and Dr. Tom W. Anderson.

August 15, 1980 — Judgment of District Court entered.

August 19, 1980 — Defendants' Notice of Appeal filed.

September 12, 1980 — Plaintiffs' Notice of Appeal filed.

June 10, 1982 — Opinion and judgment of the Court of Appeals for the Eighth Circuit.

May 24, 1983 — Memorandum and Order entered certifying to the Court of Appeals for the Eighth Circuit involving "a controlling question of law as to which there is a substantial ground for difference of opinion and that an immediate appeal from the order [might] materially advance the ultimate termination of the litigation" certain questions.

June 6, 1983 — Defendants' Petition for Permission to File Interlocutory Appeal filed.

June 20, 1983 — Order of Court of Appeals for the Eighth Circuit entered denying Petition for Permission to File Interlocutory Appeal.

December 2, 1983 — Court trial of action conducted.

February 22, 1984 — Judgment of District Court entered, awarding damages (including consideration paid, plus interest thereon, less tax benefits) as follows:

Dr. Tom W. Anderson	$50,290
Dr. Roger E. Austin	46,168
Dr. Myrel A. Neumann	60,518
Dr. William C. Randall	45,435,

awarding attorney's fees as follows:

Dr. Myrel A. Neumann	$14,000
Dr. William C. Randall	10,000,

and awarding costs.

March 26, 1984 — Amended Judgment entered, computing prejudgment interest at a rate of 8% simple interest per annum, thereby reducing the award of consideration paid, plus interest thereon, less tax benefits to:

Dr. Tom W. Anderson	$35,172
Dr. Roger E. Austin	31,277
Dr. Myrel A. Neumann	39,371
Dr. William C. Randall	31,565.

March 30, 1984 — Defendants' Notice of Appeal filed.

April 4, 1984 — Plaintiffs' Notice of Appeal filed.

July 16, 1985 — Opinion and judgment of Court of Appeals for the Eighth Circuit.

September 24, 1985 — Petition for Writ of Certiorari filed.

November 12, 1985 — Order granting certiorari entered.

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA
FOURTH DIVISION

Civil No 4-76-82

DR. ROGER E. AUSTIN, DR. TOM W. ANDERSON, DR. MYREL A. NEUMANN and DR. WILLIAM C. RANDALL,

Plaintiffs,

v.

B. J. LOFTSGAARDEN; ALOTEL INCORPORATED, a Minnesota corporation; M. S. NOAH; JOHN W. BURG; LYMAN H. COULT; ROBERT R. DUNLAP; and PROPERTY DEVELOPMENT & RESEARCH COMPANY, a Minnesota corporation,

Defendants.

FOURTH AMENDED AND SEPARATE COMPLAINT OF PLAINTIFF DR. WILLIAM C. RANDALL

Plaintiff Dr. William C. Randall, for his Complaint against Defendants, alleges and states:

JURISDICTION

1. The action arises under the Securities Act of 1933, 15 U.S.C. §§ 77a-77aa; the Securities Exchange Act of 1934, 15 U.S.C. §§ 78-a-78jj; the Minnesota Uniform Securities Act, Minn. Stat. §§ 80A.01-80A.31, and the common law of Minnesota. The matter in controversy exceeds, exclusive of interests and costs, the sum of Ten Thousand and no/100ths ($10,000.00) Dollars.

2. Subject matter jurisdiction is invoked pursuant to 15 U.S.C. § 77v; 15 U.S.C. § 78aa; 28 U.S.C. § 1331; 28 U.S.C. § 1337; and the pendent jurisdiction of the Court.

PARTIES

3. Plaintiff Dr. William C. Randall ("Randall") was and is a citizen and resident of the State of Minnesota and was a purchaser of a unit in a limited partnership purportedly organized under the laws of the State of Minnesota.

4. On information and belief, the other above-named Plaintiffs were also purchasers of limited partnership units in Alotel Associates.

5. Defendant B. J. Loftsgaarden ("Loftsgaarden") is a citizen and resident of Minnesota. Loftsgaarden organized Alotel Associates for the purpose of building, furnishing and operating a motel in Rochester, Minnesota ("Rochester Ramada"), pursuant to a licensing agreement with Ramada Inns, Inc. From the organization of Alotel Associates until September 17, 1975, Loftsgaarden acted as one of two general partners of Alotel Associates.

6. Defendant Alotel Incorporated ("Alotel Incorporated") is a corporation incorporated under the laws of the State of Minnesota having its principal place of business in the State of Minnesota. From the organization of Alotel Associates until September 17, 1975, Alotel Incorporated acted as the other of the two general partners of Alotel Associates. Loftsgaarden was and is President and sole or controlling shareholder of Alotel Incorporated.

7. Defendants Property Development and Research Company ("PDRC") and 2361 Building Corporation ("2361") are corporations incorporated under the laws of the State of Minnesota having their principal places of business in the State of Minnesota. On information and belief, Loftsgaarden was and is president and sole or controlling shareholder of both PDRC and 2361.

8. Defendants M. S. Noah, John H. Burg, Lyman H. Coult, and Robert R. Dunlap are other officers and directors of Alotel Incorporated, PDRC and 2361 and were and are citizens and residents of the State of Minnesota.

9. Defendant Touche Ross & Company ("Touche Ross") is a partnership of certified public accountants operating in the State of Minnesota.

FACTUAL BACKGROUND

10. On or about April 15, 1973, Loftsgaarden organized Alotel Associates for the purpose of building, furnishing and operating the Rochester Ramada.

11. On or about April 25, 1973, Touche Ross prepared and supplied Loftsgaarden with a forecast which purported to estimate income, expenses, cash flow and tax consequences of projected operations of the Rochester Ramada from the persons purchasing limited partnership units in Alotel Associates.

12. Between April 25, 1973, and November 13, 1973, Loftsgaarden and Alotel Incorporated supplied an Offering Memorandum concerning Alotel Associates to Randall. The Offering Memorandum contained the forecast supplied by Touche Ross. In addition, Loftsgaarden and Alotel Incorporated made certain oral representations concerning Alotel Associates to Randall.

13. On information and belief, Loftsgaarden and Alotel Incorporated supplied copies of the Offering Memorandum to the other above-named Plaintiffs. In addition, Loftsgaarden and Alotel made oral representations of a

nature similar to those made to Randall to the other above-named Plaintiffs.

14. The Offering Memorandum was false and misleading in that it failed to disclose the following material facts:

(a) PDRC was then the fee owner of tracts of land on which the Rochester Ramada was to be built and operated.

(b) Loftsgaarden was the sole or controlling stockholder of PDRC.

(c) PDRC intended to convey the tracts of land on which the Rochester Ramada was to be built and operated to Alvin A. Holasek and Ward E. Holasek by a contract for deed.

(d) PDRC intended to enter into a written lease with Alvin A. Holasek and Ward E. Holasek by which PDRC would lease back from from Alvin a Holasek and Ward E. Holasek the tracts of land on which the Rochester Ramada was to be built and operated.

(e) PDRC intended to sublet the tracts of land which it leased back from Alvin A. Holasek and Ward B. Holasek to Alotel Associates.

(f) The above-mentioned sale was to be on terms which were more favorable to PDRC than would have been obtained from disinterested parties.

(g) The price paid by Alvin A. Holasek and Ward E. Holasek was in excess of the appraised value and the fair market value of the tracts of land on which the Rochester Ramada was to be built and operated and would not

have been paid if Loftsgaarden had not agreed that Alotel Associates would enter into a lease with Alvin A. Holasek and Ward E. Holasek.

(h) PDRC's cost was less than the price to paid by Alvin A. Holasek and Ward E. Holasek.

(i) The costs of the lease with Alvin A. Holasek and Ward E. Holasek into which PDRC intended to enter would be on terms less favorable than could have been obtained from disinterested parties.

(j) The costs of the sublease with PDRC into which Alotel Associates would be required to enter would be on terms less favorable to Alotel Associates than could have been obtained from disinterested parties.

(k) Loftsgaarden was the sole or controlling stockholder of 2361.

(l) Alotel Associates would be required to pay 2361 a fee for constructing the Rochester Ramada which was neither comparable to not competitive with the fee which Alotel Associates would have been required to pay to a disinterested party rendering comparable services.

(m) Alotel Associates would be required to reimburse PDRC for a loan commitment fee paid to Progressive Underwriters of Des Moines, Iowa,

(n) Loftsgaarden expected to be paid a fee of Two Hundred Forty Thousand and no/100ths ($240,000.00) Dollars for acting as the developer of the Rochester Ramada.

(o) Loftsgaarden had been named as a defendant in *Trustees of Minnesota Bakers Union Pension Fund v.*

Loftsgaarden, File No. 380190 (Ramsey County Dist Ct.). Said action was based upon allegations that Loftsgaarden and others had violated the Minnesota Blue Sky Law and had made certain misrepresentations in connection with the sale of securities.

(p) Loftsgaarden and Alotel Incorporated never intended to require 2361 to remedy any substantial defects which might occur in the construction of the Rochester Ramada including, but not limited to, deficiencies in the air conditioning/heating system and leaks in the roof and walls of the motel building.

(q) Loftsgaarden had defrauded Steve Hawrysh, an individual with whom Loftsgaarden dealt in connection with the construction and operation of an apartment project in Marshall, Minnesota.

(r) Loftsgaarden and Alotel Incorporated intended to perform only minimal services in return for the management fee which Alotel Associates would be required to pay them.

(s) Loftsgaarden and Alotel Incorporated would cause Alotel Associates to pay them management fees in preference to operating expenses, payments of mortgage principal and interest and real estate and other taxes.

(t) Loftsgaarden would cause materials purchased for use in constructing the Rochester Ramada to be transferred from the site and to be used in constructing other real estate development projects in which Loftsgaarden had an interest.

(u) Investors might realize taxable income if and when Alotel Associates failed financially.

(v) Loftsgaarden had attempted to organize another partnership at an earlier date. The purpose of that partnership would have been to construct and operate a Ramada Inns hotel/motel on the site which the Rochester Ramada was constructed. At that time Loftsgaarden had projected that costs of construction and operation would be higher and that depreciation and profits would have been lower than the costs, depreciation and profit predicted in the Offering Memorandum.

(w) Alotel Incorporated had not been and would not be funded.

(x) Noah, Burg, Coult and Dunlap had not functioned and would not function as directors of Alotel Incorporated.

(y) One Hundred Thousand and no/100ths ($100,000.00) Dollars would not be a sufficient amount of capital to provide a reserve for initial operating expenses.

(z) Loftsgaarden expected that he or PDRC and 2361, corporations of which he was the sole or controlling shareholder, would earn substantial profits through the sale and lease-back of the land upon which the Rochester Ramada was to be located.

aa) Loftsgaarden owned a thirty (30%) percent interest in arc-TECH, Inc. Loftsgaarden and Alotel Incorporated intended to retain arc-TECH, Inc., as the architect to design and supervise the construction of the Rochester Ramada and to pay arc-TECH,Inc., the disclosed fee of Ninety Thousand and no/100ths ($90,999) Dollars.

(bb) Loftsgaarden expected that he or 2361 would receive compensation as a result of the development of the

Rochester Ramada and that compensation would not be limited to the "Overhead and Profit" disclosed on page 28 of the Offering Memorandum. That compensation was expected to be in excess of Two Hundred Forty Thousand and no/100ths ($240,000) Dollars.

(cc) PDRC, a corporation of which Loftsgaarden was the sole shareholder, would be paid a commitment fee by Alotel Associates for obtaining financing.

(dd) Alotel Associates would pay Coult, a director of Alotel Incorporated, through Coult Mortgage Corporation, a commission of Twenty-five Thousand and no/100ths ($25,000) Dollars for selling the property upon which the Rochester Ramada was to be located.

(ee) Previously Loftsgaarden had attempted unsuccessfully to organize Alotel Associates using a different Offering Memorandum. The risks associated with the reorganization of Alotel Associates increased the possibility of loss to Randall and other investors.

(ff) Loftsgaarden had caused 2361 to employ and pay Paul Crawford ("Crawford") to offer to sell, to solicit offers to buy and to sell partnership units of Alotel Associates even though the Commissioner of Securities of the State of Minnesota had suspended Crawford's license to sell such units because of his acceptance of compensation for advising persons to purchase such units.

(gg) One Hundred Thousand and no/100ths ($100,000.00) Dollars would not be a sufficient amount of capital to provide a reserve for initial operating expenses.

15. The Offering Memorandum was false and misleading in the following particulars:

(a) The Offering Memorandum stated that construction and furnishing of the Rochester Ramada could be

accomplished for a total expenditure of Three Million One Hundred Fifty Thousand and no/100ths ($3,150,000.00) Dollars. Actual costs of construction and furnishing were considerably in excess of Three Million One Hundred Fifty Thousand and no/100ths ($3,150,000.00) Dollars.

(b) The Offering Memorandum stated that total rent for the land on which the Rochester Ramada was to be located would be Thirty Seven Thousand Two Hundred and no/100ths ($37,200.00) Dollars per year. The actual rent to be paid by Alotel Associates pursuant to a lease executed by PDRC and Alotel Associates on October 24, 1973, was Seventy Thousand Two Hundred and no/100ths ($70,200.00) Dollars per year.

(c) The Offering Memorandum stated that interim construction financing would be obtained at a rate of nine and one-half (9½%) percent per annum. Interim construction financing had been obtained from the First National Bank of St. Paul at a rate which was to be four (4%) percent per annum above the prime rate. At the time that Randall purchased his limited partnership unit the prime rate was ten (10%) percent per annum and interim construction financing was costing fourteen (14%) percent per annum.

(d) The Offering Memorandum stated that a maximum of twenty (20) limited partnership units were to be sold. Eventually, twenty-five (25) such units were sold.

(e) The Offering Memorandum stated that Alotel Associates would use the proceeds from the sale of limited partnership units to construct and furnish the Rochester Ramada and to provide One Hundred Thousand and no/100ths ($100,000.00) Dollars for initial operating ex-

penses and that, if more than fourteen (14) but less than twenty (20) such units were sold, Alotel Associates might borrow funds or lease items to furnish the Rochester Ramada. Although twenty-five (25) limited partnership units were sold, Alotel Associates was required to obtain a loan and to grant a chattel mortgage in order to furnish the Rochester Ramada and did not have One Hundred Thousand and no/100ths ($100,000.00) Dollars available for initial operating expenses.

(f) The Offering Memorandum stated that construction of the Rochester Ramada would be completed on or before December 1, 1973, and that the Rochester Ramada would be opened for occupancy in December, 1973. The Rochester Ramada was not opened for occupancy until June 1, 1974.

(g) The Offering Memorandum stated that Loftsgaarden and Alotel Incorporated were to receive compensation of Eleven Thousand Five Hundred and no/100ths ($11,500.00) Dollars per year plus a percentage of the net profit of Alotel Associates. Loftsgaarden expected to be paid an additional fee of Two Hundred Forty Thousand and no/100ths ($240,000.00) Dollars for acting as developer of the Rochester Ramada.

(h) The Offering Memorandum stated that Loftsgaarden had been engaged in real estate development since 1962 and implied that his participation in such development had been conducted in a manner satisfactory to the persons who had invested in those projects. In fact, Loftsgaarden had defrauded Steve Hawrysh, an individual with whom he dealt in connection with the construction and operation of an apartment project in Marshall, Minnesota.

(i) The offering Memorandum stated the amount of the total interest which was expected to pay for interim construction financing. There was no disclosing that this expectation depended upon the prime rate remaining constant at five and one-half (5½%) percent per year and upon the completion of construction within seven (7) months.

(j) The Offering Memorandum stated that the land on which the Rochester Ramada was to be built had been leased for an initial term of forty (40) years with options for renewal executed by Alotel Associates thereafter. No such lease in fact existed, and no lease containing the terms disclosed by the Offering Memorandum was ever executed.

(k) The Offering Memorandum stated that construction of the project would begin in May 1973 and would be completed by December 1973. Loftsgaarden and PDRC and 2361, corporations of which Loftsgaarden was the sole shareholder, expected that construction would require at least one year.

(l) The Offering Memorandum stated that Alotel Associates would obtain Two Hundred Forty and no/-100ths ($240,000) Dollars by executing five-year notes at an interest rate of eight (8%) percent per annum. Alotel Associates would only be able to obtain a loan of $240,000.00 by returning a chattel mortgage on the furniture and fixtures of the Rochester Ramada and at a rate of interest which would be three (3%) percent per annum over the prime rate.

(m) The Offering Memorandum stated that long term financing of the project had been obtained from Larwin Realty & Mortgage Trust ("Larwin") at an interest

rate of nine and one-half (9½%) percent per annum. Alotel Associates could not, without using a nominee, use the commitment from Larwin because the interest rate would have benn (sic) usurious. The risk that the long term loan would be found to be usurious was so substantial that Larwin could refuse to honor its commitment without extensive assurances of the legality of its loan. Such assurances could only be provided at a substantial and undisclosed cost to Alotel Associates.

(n) The Offering Memorandum contained budgets and forecasts. Those budgets and forecasts were based upon assumptions and a rationale that were not reasonable and were misleading in light of the facts known to Loftsgaarden, PDRC and 2361.

(o) The Offering Memorandum stated that Alotel Associates would enter into a fixed fee construction contract with a construction company owned or controlled by persons owning or controlling Alotel Incorporated for the construction and furnishing of the Rochester Ramada Inn for a total expenditure of $3,150,000. Loftsgaarden did not cause Alotel Associates and 2361 to execute such a contract and did not intend to do so.

(p) The Offering Memorandum stated the identity of the officers and directors of Alotel Incorporated. Those officers and directors had not agreed to be active as directors and officers. It did not disclose that Alotel Incorporated had not been and would not be funded or that Loftsgaarden did not intend to act as an active or financially responsible general partner.

(q) The Offering Memorandum stated that it would not be registered with the State of Minnesota or with the

Securities and Exchange Commission. It did not disclose that the failure to registration would mean that the Commissioner of Securities of the State of Minnesota would not pass upon whether the Offering Memorandum would be fair and equitable as required by Minnesota law as he would if the Offering Memorandum had been submitted to him for registration. It did not disclose that the Offering would not have been approved if it had been submitted to the Commissioner of Securities because it was inconsistent with the disclosure and fairness rules which had been adopted by the Commissioner.

(r) The Offering Memorandum stated that the partnership agreement provided that unless seventy (70%) percent of the units had been sold within one hundred eighty (180) days of the date of the sale of the first unit, the partnership would terminate and all funds would be returned to investors. Loftsgaarden had commenced construction and had committed himself to raise Eight Hundred Seventy-five Thousand and no/100ths ($875,000.00) Dollars as investor capital and could not afford to and never intended to return funds to investors.

16. On or about November 13, 1973, in response to a solicitation from and an offer to sell by Loftsgaarden and Alotel Incorporated, and in reliance on representations made in the Offering Memorandum and otherwise, Randall subscribed to purchase one (1) limited partnership unit in Alotel Associates for Thirty-five Thousand and no/100ths ($35,000.00) Dollars. At that time, Randall made payment of Two Thousand and no/100ths ($2,000.00) Dollars of the purchase price. On or before December 1, 1973, Randall made payment of the balance.

17. On information and belief, the other above-named Plaintiffs also purchased limited partnership units in Alotel Associates.

18. On or about March 13-14, 1975, Loftsgaarden and Alotel Incorporated communicated to Randall that Alotel Associates was experiencing cash flow problems, that Randall's limited partnership interest was in jeopardy and that those problems could be resolved and Randall's partnership interest protected if Randall and each other holder of a limited partnership unit would make a non-recourse loan in the amount of Three Thousand Five Hundred and no/100ths ($3,500.00) Dollars to Alotel Associates.

19. That representation was false and misleading in that loans of Three Thousand Five Hundred and no/100ths ($3,500.00) Dollars by every owner of a limited partnership unit would not be and was not sufficient to resolve the cash flow problems of Alotel Associates or to protect Randall's financial interests.

20. On or about April 14, 1975, in response to the March 13-14, 1975 communications from Loftsgaarden and Alotel Associates, Randall loaned Three Thousand Five Hundred and no/100ths ($3,500.00) Dollars to Alotel Associates.

21. On information and belief, the other above-named Plaintiffs made similar loans.

22. On or about May 16, 1975, Loftsgaarden and Alotel Incorporated communicated to Randall that Alotel Associates was experiencing additional cash flow problems, that Randall's partnership interest was in jeopardy and that those problems could be resolved and Randall's part-

nership interest protected if Randall and each other holder of a limited partnership unit would loan an additional Two Thousand Two Hundred Fifty and no/100ths ($2,250.00) Dollars to Alotel Associates.

23. That representation was false and misleading in that loans of Two Thousand Two Hundred Fifty and no/100ths ($2,250.00) Dollars by every owner of a limited partnership unit would not be and was not sufficient to resolve the cash flow problems of Alotel Associates or to protect Randall's financial interests.

24. On or about May 31, 1975, in response to the May 16, 1975 communications from Loftsgaarden and Alotel Associates, Randall loaned an additional One Thousand Two Hundred Fifty and no/100 ($1,250.00) Dollars to Alotel Associates.

24a. On information and belief, the other above-named Plaintiffs made similar loans.

24b. On or about December 31, 1975, in response to the March 13-14, 1975, and May 16, 1975 communications from Loftsgaarden and Alotel Associates and in response to communications from others, Randall loaned an additional Two Thousand Seven Hundred Fifty and no/100ths ($2,750.00) Dollars to Alotel Associates.

25. On information and belief, the other above-named Plaintiffs made similar loans.

CAUSES OF ACTION

Count One

26. Plaintiff Randall realleges all of the allegations contained in Paragraphs 1 through 25 herein and incorporates the same by reference as if set forth in full herein.

27. Loftsgaarden and Alotel Incorporated offered to sell and sold one (1) limited partnership in Alotel Associates to Randall by the use of means and instruments of transportation and communication in interstate commerce and by the use of the mails.

28. Loftsgaarden and Alotel Incorporated either had knowledge or pursuant to reasonable investigation should have had knowledge of said untrue statements and omissions.

28a. Loftsgaarden and Alotel Incorporated continued to fraudulently conceal their untrue statements and omissions by making additional untrue statements and omissions.

28b. Randall diligently examined all financial statements and other materials provided to him by Loftsgaarden and Alotel Incorporated and questioned Loftsgaarden and Alotel Incorported about the financial condition of Alotel Associates. Loftsgaarden and Alotel Incorporated continued to reassure Randall that their earlier statements to him were true and that their projections would prove to be true. Randall accepted those reassurances.

29. Randall relied on each of said untrue statements and omissions.

30. Said untrue statements and omissions constitute violations of Section 12(2) of the Securities Act of 1933, 15 U.S.C. § 77.

30a. On or about November 13, 1973, Loftsgaarden and Alotel Incorporated delivered the Offering Memorandum to Randall. The Offering Memorandum contained and omitted the matters alleged in Paragraphs 14 and 15.

30b. On or about February 12, 1975, and on or about March 13-14, 1975, Loftsgaarden and Alotel Incorporated communicated the matters alleged in Paragraph 18. Those matters were communicated by letter and at a meeting of limited partners of Alotel Associates.

30c. Randall employed John Essene, an accountant, and Douglas M. McMillan, an attorney, to investigate Loftsgaarden and Alotel Incorporated's dealings with Alotel Associates. However, because Loftsgaarden and Alotel Incorporated failed to maintain books and records for Alotel Associates in a fashion which would permit Randall or his agents to determine Alotel Associates' financial condition or to discover Loftsgaarden or Alotel Incorporated's misrepresentations or omissions and because Loftsgaarden and Alotel Incorporated continued to reassure Randall and his agents that Loftsgaarden and Alotel Incorporated had and would continue to manage the affairs of Alotel Associates in businesslike manner, neither Randall nor his agents were able to discover Loftsgaarden and Alotel Incorporated's misbehavior.

30d. On or about November 1, 1975, Gene Happe, an attorney, first discovered what he considered to be fraud by Loftsgaarden and Alotel Incorporated. He reported his discovery of potential fraud to Randall at a subsequent time. Shortly thereafter, Plaintiffs' attorneys, Happe & Happe, by Dale J. Happe, commenced this action.

31. By virtue of Loftsgaarden's and Alotel Incorporated's violations of Section 12(2), Randall has been damaged in the amount of Forty-two Thousand Five Hundred and no/100ths ($42,500.00) Dollars.

Count Two

32. Randall realleges all of the allegations contained in Paragraphs 1 through 31 herein and incorporates the same by reference as if set forth in full herein.

33. Said untrue statements and omissions constitute violations of Section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a).

34. By virtue of Loftsgaarden's and Alotel Incorporated's violations of Section 17(a), Randall has been damaged as set forth in Count One.

Count Three

35. Randall realleges all of the allegations contained in Paragraphs 1 through 34 herein and incorporates the same by reference as if set forth in full herein.

36. Said untrue statements and omissions constitute violations of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and of Rule 10b-5 of the Securities Exchange Commission, 17 C.F.R. § 240.10b-5.

37. By virtue of Loftsgaarden's and Alotel Incorporated's violations of Section 10(b) and of Rule 10b-5, Randall has been damaged as set forth in Counts One and Two.

Count Four

38. Randall realleges all of the allegations contained in Paragraphs 1 through 37 herein and incorporates the same by reference as if set forth in full herein.

39. Said untrue statements and omissions constitute violations of Minn. Stat. § 80A.01 and of Minn. Stat. § 80A.03.

40. By virtue of Loftsgaarden's and Alotel Incorporated's violations of Minn. Stat. § 80A.01 and of Minn. Stat. § 80A.03, thereon, Randall has been damaged as set forth in Counts One through Three.

Count Five

41. Randall realleges all of the allegations contained in Paragraphs 1 through 40 herein and incorporates the same by reference as if set forth in full herein.

42. Loftsgaarden and Alotel Incorporated, as the general partners of Alotel Associates, owed a fiduciary duty to Randall, as a limited partner of Alotel Associates, to operate Alotel Associates in a fair, just and equitable manner. As partners with fiduciary duties, Loftsgaarden and Alotel Incorporated had no right to use their power to control partnership activities to benefit themselves alone and were not permitted to act in any manner which might be detrimental to the rights of the limited partners.

43. Loftsgaarden and Alotel Incorporated breached their fiduciary duties to Randall in a number of ways, including, but not limited to, the following:

(a) Loftsgaarden and Alotel Incorporated, acting on behalf of Alotel Associates, executed a contract with 2361 for the construction of the motel building. Said contract permitted 2361 to derive a construction fee which was in excess of a fee comparable to and competitive with the fee of disinterested persons willing to render comparable services.

(b) Loftsgaarden, individually or as President and sole or controlling shareholder of PDRC, earned commissions and profits from the various real estate transactions

which culminated in the lease of the tracts of land on which the Rochester Ramada was to be built and operated to Alotel Associates.

(c) Loftsgaarden and Alotel Incorporated failed to require 2361 to remedy the defects in 2361's construction of the Rochester Ramada, including, but not limited to, deficiencies in the air conditioning-heating system and leaks in the roof and walls.

(d) Loftsgaarden and Alotel Incorporated failed to properly account for partnership funds in that they permitted cost of constructing the Rochester Ramada to be charged to Alotel Associates as operating costs and made payments of interest from partnership funds for debts incurred by entities other than Alotel Associates for projects unrelated to the activities of Alotel Associates.

(e) Loftsgaarden and Alotel Incorporated failed to close the permanent financing in a timely fashion. Said failure to close resulted in additional interest costs to Alotel Associates.

(f) Loftsgaarden and Alotel Incorporated failed to maintain financial records sufficient to permit Randall to ascertain the mismanagement and breaches of fiduciary duty by Loftsgaarden and Alotel Associates.

(g) Loftsgaarden, as President and sole or controlling stockbroker of PDRC, usurped Alotel Associates' opportunity to lease the tracts of land on which the Rochester Ramada was to be built and operated from Alvin A. Holasek and Ward E. Holasek for Thirty-Seven Thousand Two Hundred and no/100ths ($37,200.00) Dollars per year. Alotel Associates was then required to lease the tracts of

land from PDRC for Seventy Thousand Two Hundred and no/100ths ($70,200.00) Dollars per year.

44. By virtue of Loftsgaarden's and Alotel Incorporated's breaches of their fiduciary duties to Randall, Randall was damaged in the amount of Forty-two Thousand Five Hundred and no/100ths ($42,500.00) Dollars.

Count Six

45. Randall realleges all of the allegations contained in Paragraphs 1 through 44 herein and incorporates the same by reference as if set forth in full herein.

46. Loftsgaarden and Alotel Incorporated either had knowledge, or pursuant to reasonable investigation, should have had knowledge that their statements were untrue and that the facts which they omitted were necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.

47. Said untrue statements and omissions concerned material facts. Randall relied on the misrepresentations and omissions made by Loftsgaarden and Alotel Incorporated.

48. By reason of the misrepresentations and omissions by Loftsgaarden and Alotel Incorporated, Randall has been damaged as set forth in Counts One through Five.

Count Seven

49. Randall realleges all of the allegations contained in Paragraphs 1 through 48 herein and incorporates the same by reference as if set forth in full herein.

50. Noah, Burg, Coult and Dunlap exercised control over Alotel Incorporated.

51. Pursuant to Section 15 of the Securities Act of 1933, 15 U.S.C. § 77, and Section 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78t(a), Noah, Burg, Coult and Dunlap are liable jointly and severally with Alotel Incorporated for Alotel Incorporated's violations of Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 of the Securities Exchange Commission.

Count Eight

52. Randall realleges all of the allegations contained in Paragraphs 1 through 51 herein and incorporates the same by reference as if set forth in full herein.

53. Noah, Burg, Coult and Dunlap controlled and were directors of Alotel Incorporated.

54. Pursuant to Minn Stat. § 80A.23, subd. 3, Noah, Burg, Coult and Dunlap are liable jointly and severally with Alotel Incorporated for Alotel Incorporated's violations of Minn. Stat. §§ 80A.01 and 80A.03.

Count Nine

55. Randall realleges all of the allegations contained in Paragraphs 1 through 54 herein and incorporates the same by reference as if set forth in full herein.

56. Touche Ross either did not believe or pursuant to reasonable investigation should not have believed that its forecast concerning income, expenses, cash flow and tax consequences of projected operations of the Rochester Ramada was reliable. Touche Ross either knew or pursuant to reasonable investigation should have known that its forecast would be used to induce persons to purchase limited partnership units in Alotel Associates.

57. Said forecast was not realiable in that:

(a) The information provided to Touche Ross upon which Touche Ross based its conclusion that the experience of certain other Ramada Inn projects could be considered comparable to the proposed Rochester Ramada was an inadequate basis upon which to rest such a conclusion.

(b) Projected expenses were grossly understated.

(c) Projected operating income and cash flow were grossly overstated.

58. Touche Ross either had knowledge or pursuant to reasonable investigation should have had knowledge that said forecast was to be included in the Offering Memordum.

59. Randall relied on the forecast prepared and supplied by Touche Ross to Loftsgaarden and Alotel Incorporated.

60. Said forecast constitutes a violation of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 of the Securities Exchange Commission, 17 C.F.R. § 240.10b-5.

61. By virtue of Touche Ross' violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 of the Securities Exchange Commission, Randall has been damaged as set forth in Counts One through Nine.

Count Ten

61a. Randall realleges all of the allegations contained in Paragraphs 1 through 61 herein and incorporates the same by reference as it set forth in full herein.

61b. The conduct of Loftsgaarden, Alotel Incorporated, Noah, Burg, Coult, Dunlap and Touche Ross toward Randall, including but not limited to misrepresentations and omissions, management of Alotel Associates and the construction, furnishing and operation of the Rochester Ramada and the preparation and provision of the financial forecast was negligent.

61c. By virtue of the negligence of Loftsgaarden, Alotel Incorporated, Noah, Burg, Coult, Dunlap and Touche Ross, Randall has been damaged as set forth in Counts One through Ten.

Count Eleven

62. Randall realleges all of the allegations contained in Paragraphs 1 through 61c herein and incorporates the same by reference as if set forth in full herein.

63. Loftsgaarden's conduct was willful, wanton and malicious.

64. By virtue of Loftsgaarden's willful, wanton and malicious conduct, Randall is entitled to damages in a reasonable amount. Pursuant to Minn. Stat. § 544.36 (1978) Randall alleges that amount to exceed Fifty Thousand and no/100ths ($50,000.00) Dollars.

PRAYER FOR RELIEF

WHEREFORE, Plaintiff Dr. William C. Randall prays for judgment against Defendants Alotel Incorporated, M. S. Noah, John H. Burg, Lyman H. Coult, Robert R. Dunlap, Property Development and Research Company, 2361 Building Corporation and Touche Ross & Company,

and each of them, in the sum of Forty-Two Thousand Five Hundred and no/100ths ($42,500.00) Dollars, together with interest thereon, a reasonable attorney's fee, and Plaintiff Dr. William C. Randall's costs and disbursements herein, and against Defendant B. J. Loftsgaarden in the sum of Forty-Two Thousand Five Hundred and no/100ths ($42,-500.00) Dollars, together with interest thereon, punitive damages in a reasonable amount, a reasonable attorney's fee, and Plaintiff's costs and disbursements herein.

Dated: June — , 1980.

O'CONNOR & HANNAN

By———————

Douglas M. McMillan
Robert A. Brunig
William D. Hull
Thirty-Eighth Floor, IDS Tower
80 South Eighth Street
Minneapolis, Minnesota 55402
Telephone: (612) 341-3800

Attorneys for Plaintiff
Dr. William C. Randall

JURY TRIAL DEMANDED

THIRD AMENDED AND SEPARATE COMPLAINT OF

DR. MYREL A. NEUMANN

DR. THOMAS W. ANDERSON

DR. ROGER E. AUSTIN

(Title Omitted in Printing)

Filed June 16, 1980

Plaintiffs DR. MYREL A. NEUMANN, DR. THOMAS W. ANDERSON and DR. ROGER E. AUSTIN, for their Complaint against Defendants, allege and state:

JURISDICTION

1. The action arises under the Securities Actof 1933, 15 U.S.C. §§ 772-7722; the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78jj; the Minnesota Uniform Securities Act, Minn. Stat. §§ 80A.01-80A.31 (1976); and the Common Law of Minnesota. The amount in controversy as to each Plaintiff exceeds, exclusive of interest and costs, the sum of Ten Thousand ($10,000) Dollars.

2. Subject matter jurisdiction is invoked pursuant to 15 U.S.C. § 77v; 15 U.S.C. § 78aa; 28 U.S.C. § 1331; 28 U.S.C. § 1337; and the pendent jurisdiction of the Court.

PARTIES

3. Plaintiffs DR. MYREL A. NEUMANN, DR. THOMAS W. ANDERSON and DR. ROGER E. AUSTIN ("NEUMANN, ANDERSON and AUSTIN") were and are citizens and residents of the State of Minnesota and were purchasers of limited partnership units in Alotel Associates, a Limited Partnership organized under the laws of the State of Minnesota.

4. On information and belief, the other above-named Plaintiffs were also purchasers of limited partnership units in Alotel Associates.

5. Defendant B. J. LOFTSGAARDEN ("LOFTSGAARDEN") is a citizen and resident of the State of Minnesota. LOFTSGAARDEN organized Alotel Associates for the purpose of building, furnishing and operating a motel in Rochester ("Rochester Ramada"), pursuant to a licensing agreement with Ramada Inns, Inc. From the organization of Alotel Associates until September 17, 1975, LOFTSGAARDEN acted as one of the two general partners in Alotel Associates.

6. Defendant ALOTEL INCORPORATED ("ALOTEL INCORPORATED") is a corporation incorporated under the laws of the State of Minnesota, having its principal place of business in the State of Minnesota. From the organization of Alotel Associates until September 17, 1975, ALOTEL INCORPORATED acted as the other of the two general partners of Alotel Associates. LOFTSGAARDEN was and is President and sole or controlling shareholder of ALOTEL INCORPORATED.

7. Defendants PROPERTY DEVELOPMENT AND RESEARCH COMPANY ("PDRC"), and 2361 BUILDING CORPORATION ("2361") are corporations incorporated under the laws of the State of Minnesota, having their principal places of business in the State of Minnesota. On information and belief, LOFTSGAARDEN was and is President and sole or controlling shareholder of both PDRC and 2361.

8. Defendants M. S. NOAH, JOHN H. BURG, LYMAN H. COULT and ROBERT R. DUNLAP are other

officers and directors of said corporations and were and are citizens and residents of the State of Minnesota.

9. Defendant TOUCHE ROSS & COMPANY ("TOUCHE ROSS") is a partnership of certified public accountants operating in the State of Minnesota.

FACTUAL BACKGROUND

10. On or about April 15, 1973, LOFTSGAARDEN organized Alotel Associates for the purpose of building, furnishing and operating the Rochester Ramada.

11. On or about April 25, 1973, TOUCHE ROSS prepared and supplied LOFTSGAARDEN with an estimate of income, expenses, cash flow and tax consequences of projected operations of the Rochester Ramada for the persons purchasing limited partnership units in Alotel Associates.

12. LOFTSGAARDEN and ALOTEL INCORPORATED supplied an Offering Memorandum concerning Alotel Associates to NEUMANN between April 25 and August 21, 1973, to ANDERSON between April 25 and July, 1973 and to AUSTIN between April 25 and June 26, 1973. The Offering Memorandum contained the estimates supplied by TOUCHE ROSS. In addition, LOFTSGAARDEN and ALOTEL INCORPORATED made certain oral representations concerning Alotel Associates to NEUMANN, ANDERSON and AUSTIN.

13. On information and belief, LOFTSGAARDEN and ALOTEL INCORPORATED supplied copies of the Offering Memorandum to the other above-named Plain-

tiffs. In addition, LOFTSGAARDEN and ALOTEL INCORPORATED made oral representations of a nature similar to those made to NEUMANN, ANDERSON and AUSTIN to the other above-named Plaintiffs.

14. The Offering Memorandum was false and misleading in that it failed to disclose the following material facts:

(a) There was no disclosure of the profit that Loftsgaarden expected that he or his companies would make through the sale and lease-back of the land upon which the Rochester Ramada Inn was to be located.

(b) There was no disclosure that arc-TECH, inc. was the architect which would earn the disclosed fee of $90,000.

(c) There was no disclosure that the compensation LOFTSGAARDEN expected that he or his companies would receive as a result of the development of the Rochester Ramada Inn was not limited to the "Overhead and Profit" disclosed on page 28 of the Offering Memorandum but included other compensation and profit and was expected to be in excess of $240,000.

(d) There was no disclosure that PDRC or another of LOFTSGAARDEN'S controlled corporations would be paid a commitment fee by Alotel Associates for obtaining financing.

(e) There was no disclosure that Lyman H. Coult, a director of the corporate general partner, through Coult Mortgage Corporation would receive a commission of $25,000 for selling the property upon which the Rochester Ramada Inn was to be located.

(f) There was no disclosure that LOFTSGAARDEN had attempted unsuccessfully to organize Alotel Associates using a different Offering Memorandum and no disclosure of the risks associated with the reorganization of the limited partnership.

(g) There was no disclosure that Paul Crawford, who had been engaged by LOFTSGAARDEN to sell limited partnership units of Alotel Associates, was not licensed to do so.

(h) There was no disclosure that One Hundred Thousand and no/100ths ($100,000.00) Dollars would not be a sufficient amount of capital to provide a reserve for initial operating expenses.

15. The Offering Memorandum was false and misleading in the following particulars:

(a) The Offering Memorandum disclosed on page 6 that interim construction financing would be obtained at a rate of 9½% per year but did not disclose that the rate of construction loan interest would actually float at 4% over the prime rate charged by the First National Bank of St. Paul.

(b) The Offering Memorandum disclosed on page 28 the total expected construction loan interest but did not disclose that this expectation depended upon the prime rate remaining constant at 5½% per year and construction being completed in only seven months on December 31, 1973.

(c) The Offering Memorandum disclosed on page 6 that the land on which the Rochester Ramada Inn was to be built was leased for an initial term of 40 years with renewal options extending thereafter but no such lease in fact existed and no lease entered into subsequently contained the terms disclosed by the Offering Memorandum.

(d) The Offering Memorandum disclosed on page 32 that construction of the project would begin in May of 1973 and would be completed by December, 1973 and did not disclose that LOFTSGAARDEN and his companies expected that construction would take at least one year.

(e) The Offering Memorandum disclosed on page 33 that $240,000 would be obtained on five-year

notes with interest at 8% but did not disclose that such a loan would be secured by a chattel mortgage of the furniture and fixtures of the Rochester Ramada Inn and did not disclose that the rate of interest would actually float at 3% over the prime rate.

(f) The Offering Memorandum disclosed on page 6 that long term financing of the project had been obtained from Larwin Realty & Mortgage Trust at the rate of 9½% per annum but did not disclose that Alotel Associates could not, without using a nominee, make use of this commitment because the interest rate was usurious. It was also not disclosed that the risk that the long term loan would be found to be usurious was so substantial that the long term lender could refuse to honor its commitment without extensive assurance of the safety of its loan all at substantial and undisclosed cost to Alotel Associates.

(g) The budgets and forecasts contained in the Offering Memorandum beginning at page 24 were based upon assumptions and rationale that were not reasonable and not misleading in light of the facts known to LOFTSGAARDEN and his companies.

(h) The Offering Memorandum disclosed on page 5 that Alotel Associates would enter into a fixed fee construction contract with a construction company owned or controlled by persons owning or controlling ALOTEL INCORPORATED for the construction and furnishing of the Rochester Ramada Inn for a total expenditure of $3,150,000 but no such contract for such a fixed fee was ever entered into.

(i) The Offering Memorandum disclosed on page 7 the identity of the officers and directors of ALOTEL INCORPORATED but did not disclose that all had not agreed to become active directors and officers nor did it disclose that ALOTEL INCORPORATED had not been and would not be funded and was not intended by LOFTSGAARDEN to ever be an active and financially responsible general partner.

(j) The offering Memorandum disclosed on page 17 that it would not be registered with the State of Minnesota or with the Securities and Exchange Commission but did not disclose that avoiding Registration meant that the Commissioner of Securities of the State of Minnesota would not pass upon whether the Offering Memorandum would be fair and equitable as required by Minnesota law when such memoranda are submitted for registration and that the Offering would not have been passed if submitted to the Security Commissioner because it was inconsistent with the disclosure and fairness rules followed by the Commissioner.

16. On or about August 21, 1973, in response to a solicitation from and an offer to sell by LOFTSGAARDEN and ALOTEL INCORPORATED, and in reliance on representations made in the Offering Memorandum and otherwise, Plaintiff NEUMANN subscribed to purchase one (1) limited partnership unit in Alotel Associates for Thirty-five Thousand ($35,000) Dollars. On or about August 22, 1973, NEUMANN made payment of Fourteen Thousand ($14,000) Dollars of the purchase price. On or about October 19, 1973, NEUMANN subscribed to purchase an additional one half (½) partnership unit for Seventeen Thousand Five Hundred ($17,500) Dollars and paid that sum on or about October 9, 1973.

17. In or about July, 1973, in response to a solicitation from and an offer to sell by LOTTSGAARDEN and ALOTEL INCORPORATED, and in reliance on representations made in the Offering Memorandum and otherwise, Plaintiff ANDERSON subscribed to purchase one (1) limited partnership unit in Alotel Associates for Thirty-five Thousand ($35,000) Dollars. The full price for said unit was paid shortly thereafter.

18. On or about June 26, 1973, in response to a solicitation from and an offer to sell by LOFTSGAARDEN and ALOTEL INCORPORATED, and in reliance on representations made in the Offering Memorandum and otherwise, Plaintiff AUSTIN subscribed to purchase one (1) limited partnership unit in Alotel Associates for Thirty-five Thousand ($35,000) Dollars. AUSTIN made payment of the purchase price, in or before October, 1973.

19. On information and belief, the other above-named Plaintiffs also purchased limited partnership units in Alotel Associates.

20. During February and March, 1975, LOFTSGAARDEN and ALOTEL INCORPORATED communicated on behalf of Alotel Associates to NEUMANN that Alotel Associates was experiencing cash flow problems, that NEUMANN's partnership interest was in jeopardy, and that those problems could be resolved and NEUMANN's partnership interest protected if NEUMANN and each other holder of a limited partnership unit would contribute at least an additional Three Thousand Five Hundred ($3,500) Dollars and up to Eight Thousand ($8,000) Dollars per unit to Alotel Associates before May 31, 1975.

21. During March, 1975, LOFTSGAARDEN and ALOTEL INCORPORATED communicated on behalf of ALOTEL INCORPORTED to ANDERSON that Alotel Associates was experiencing cash flow problems, that ANDERSON's partnership interest was in jeopardy, and that those problems could be resolved and ANDERSON's partnership interest protected if ANDERSON and each other holder of a limited partnership unit would contribute at least an additional Three Thousand Five Hundred ($3,500)

Dollars and up to Eight Thousand ($8,000) Dollars per unit to Alotel Associates before May 31, 1975.

22. During February or March, 1975, LOFTSGAARDEN and ALOTEL INCORPORATED communicated on behalf of Alotel Associates to AUSTIN that Alotel Associates was experiencing cash flow problems, that AUSTN's partnership interest was in jeopardy, and that those problems could be resolved and AUSTIN's partnership interest protected if AUSTIN and each other holder of a limited partnership unit would contribute at least an additional Three Thousand Five Hundred ($3,500) Dollars and up to Eight Thousand ($8,000) Dollars per unit to Alotel Associates before May 31, 1975.

23. Those representations were false and misleading in that the contribution of Eight Thousand ($8,000) Dollars per unit by each holder of a limited partnership unit would not be and was not sufficient to resolve the cash flow problems of Alotel Associates or to protect NEUMANN's, ANDERSON's and AUSTIN's financial interests.

24. In response to and reliance upon the February and March, 1975 communications from LOFTSGAARDEN and ALOTEL INCORPORATED, NEUMANN, ANDERSON and AUSTIN each contributed additional monies to Alotel Associates. NEUMANN contributing Five Thousand Two Hundred Fifty ($5,250) Dollars on April 12, 1975, ANDERSON contributed Three Thousand Five Hundred ($3,500) Dollars on April 25, 1975, and AUSTIN contributed Three Thousand Five Hundred ($3,500) Dollars on March 19, 1975.

25. On information and belief, the other above-named Plaintiffs made similar contributions.

26. During May, 1975 LOFTSGAARDEN and ALOTEL INCORPORATED communicated on behalf of Alotel Associates to NEUMANN that Alotel Associates was experiencing additional cash flow problems, that NEUMANN's partnership interest was in jeopardy and that those problems could be resolved and NEUMANN's partnership interest protected, if NEUMANN and each other holder of a limited partnership unit would contribute an additional Twenty-Five Hundred ($2,500) Dollars per unit to Alotel Associates.

27. During May, 1975, LOFTSGAARDEN and ALOTEL INCORPORATED communicated on behalf of Alotel Associates to ANDERSON that Alotel Associates was experiencing additional cash flow problems, that ANDERSON's partnership interest was in jeopardy, and that those problems could be resolved and ANDERSON's partnership interest protected, if ANDERSON and each other holder of a limited partnership unit would contribute an additional Two Thousand Five Hundred ($2,500) Dollars per unit to Alotel Associates.

28. During May, 1975, LOFTSGAARDEN and ALOTEL INCORPORATED communicated on behalf of Alotel Associates to AUSTIN that Alotel Associates was experiencing additional cash flow problems, that AUSTIN's partnership interest was in jeopardy, and that those problems could be resolved and AUSTIN's partnership interest protected, if AUSTIN and each other holder of a limited partnership unit would contribute an additional Two Thousand Five Hundred ($2,500) Dollars per unit to Alotel Associates.

29. Those representations were false and misleading in that the contribution of Two Thousand Five Hundred

($2,500) Dollars per unit by each holder of a limited partnership unit would not be and was not sufficient to resolve the cash flow problems of Alotel Associates or to protect NEUMANN's, ANDERSON's and AUSTIN's financial interests.

30. In response to and reliance upon the May, 1975 communications from LOFTSGAARDEN and ALOTEL INCORPORATED, NEUMANN, ANDERSON and AUSTIN each contributed additional monies to Alotel Associates. NEUMANN contributing One Thousand Five Hundred ($1,500) Dollars on May 30, 1975, ANDERSON contributed One Thousand ($1,000) Dollars during August, 1975, and AUSTIN contributed One Thousand ($1,000) Dollars on or about June 6, 1975.

31. On information and belief, the other above-named Plaintiffs made similar contributions.

32. In response to and reliance upon the February, March and May, 1975 communications from LOFTSGAARDEN and ALOTEL INCORPORATED and in response to communications from others on behalf of Alotel Associates, NEUMANN, ANDERSON and AUSTIN each contributed additional monies to Alotel Associates. NEUMANN contributed One Thousand Eight Hundred Seventy-Five ($1,875) Dollars on September 26, 1975; Two Thousand Two Hundred Fifty ($2,250) Dollars on October 31, 1975; One Thousand Eight Hundred Seventy Five ($1,875) Dollars on December 15, 1975 and Six Thousand ($6,000) Dollars on April 3, 1976. ANDERSON contributed One Thousand Two Hundred Fifty ($1,250) Dollars on September 29, 1975; One Thousand Five Hundred ($1,500) Dollars on October 28, 1975; and One Thousand Two Hun-

dred Fifty ($1,250) on December 31, 1975. AUSTIN contributed One Thousand Two Hundred Fifty ($1,250) Dollars on September 24, 1975; One Thousand Five Hundred ($1,500) Dollars on November 5, 1975; One Thousand Two Hundred Fifty ($1,250) Dollars in December, 1975.

33. On information and belief the other above named Plaintiffs made other or similar contributions.

COUNT ONE

34. Plaintiffs NEUMANN, ANDERSON and AUSTIN reallege all of the allegations contained in Paragraphs 1 through 33 herein and incorporate the same by reference as if set forth in full herein.

35. LOFTSGAARDEN and ALOTEL INCORPORATED offered to sell and sold one (1) limited partnership unit to NEUMANN, ANDERSON and AUSTIN by the use of means and instruments of transportation and communication in interstate commerce and by the use of the mails.

36. LOFTSGAARDEN and ALOTEL INCORPORATED either had knowledge or, pursuant to reasonable investigation, should have had knowledge of said untrue statements and omissions.

37. LOFTSGAARDEN and ALOTEL INCORPORATED fraudulently concealed their untrue statements and omissions by making additional untrue statements and omissions.

38. NEUMANN, ANDERSON and AUSTIN each diligently examined all financial statements and other materials provided to them by LOFTSGAARDEN and ALO-

TEL INCORPORATED and questioned LOFTSGAARDEN and ALOTEL INCORPORATED about the financial condition of Alotel Associates. LOFTSGAARDEN and ALOTEL INCORPORATED continued to reassure NEUMANN, ANDERSON and AUSTIN that their earlier statements to them were true and that their projections would prove to be true. NEUMANN, ANDERSON and AUSTIN accepted those reassurances.

39. NEUMANN, ANDERSON and AUSTIN in conjunction with other above-named Plaintiffs and limited partners of Alotel Associates also retained attorneys and accountants to review the materials provided to them by LOFTSGAARDEN and ALOTEL INCORPORATED to better enable them to question LOFTSGAARDEN and ALOTEL INCORPORATED about the financial condition of Alotel Associates.

40. NEUMANN, ANDERSON and AUSTIN each relied on each of said untrue statements and omissions.

41. Said untrue statements and omissions constitute violations of Section 12(2) of the Securities Act of 1933, 15 U.S.C. § 77.

42. NEUMANN, ANDERSON and AUSTIN discovered that the statements were untrue or that LOFTSGAARDEN and ALOTEL INCORPORATED had failed to state material facts on or after September 10, 1975.

43. On or about September 10, 1975, the attorneys for the limited partners of Alotel Associates wrote them including NEUMANN, ANDERSON and AUSTIN to advise them that matters brought to their attention in the previous week might form the basis for what became the instant action.

44. By virtue of LOFTSGAARDEN's and ALOTEL INCORPORATED's violations of Section 12(2), NEUMANN has been damaged in the amount of Sixty Five Thousand Two Hundred Fifty ($65,250) Dollars.

45. By virtue of LOFTSGAARDEN's and ALOTEL INCORPORATED's violation of Section 12(2), ANDERSON has been damaged in the amount of Forty-three Thousand Five Hundred ($43,500) Dollars.

46. By virtue of LOFTSGAARDEN's and ALOTEL INCORPORATED's violations of Section 12(2), AUSTIN has been damaged in the amount of Forty-three Thousand Five Hundred ($43,500) Dollars.

COUNT TWO

47. Plaintiffs NEUMANN, ANDERSON and AUSTIN reallege all of the allegations contained in Paragraphs 1 through 46 herein and incorporate the same by reference as if set forth in full herein.

48. Said untrue statements and omissions constitute violations of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and of Rule 10b-5 of the Securities Exchange Commission, 17 C.F.R. § 240.10b-5.

49. By virtue of LOFTSGAARDEN's and ALOTEL INCORPORATED's violations of Section 10(b) and of Rule 10b-5, NEUMANN, ANDERSON and AUSTIN have each been damaged as set forth in Count One.

COUNT THREE

50. Plaintiffs NEUMANN, ANDERSON and AUSTIN reallege all of the allegations contained in Paragraphs

1 through 49 herein and incorporate the same by reference as if set forth in full herein.

51. Said untrue statements and omissions constitute violations of Minn. Stat. § 80A.01 and of Minn. Stat. § 80A.03.

52. By virtue of LOFTSGAARDEN's and ALOTEL INCORPORATED's violations of Minn. Stat. §80A.01 and of Minn. Stat. §80A.03, thereon, NEUMANN, ANDERSON and AUSTIN have been damaged as set forth in Counts One and Two.

COUNT FOUR

53. Plaintiffs NEUMANN, ANDERSON and AUSTIN reallege all of the allegations contained in Paragraphs 1 through 52 herein and incorporate the same by reference as if set forth in full herein.

54. LOFTSGAARDEN and ALOTEL INCORPORATED, as the general partners of Alotel Associates, owed a fiduciary duty to NEUMANN, ANDERSON and AUSTIN, as limited partners of Alotel Associates, to operate Alotel Associates in a fair, just and equitable manner. As partners with fiduciary duties, LOFTSGAARDEN and ALOTEL INCORPORATED had no right to use their power to control partnership activities to benefit themselves alone and were not permitted to act in any manner which might be detrimental to the rights of the limited partners.

55. LOFTSGAARDEN and ALOTEL INCORPORATED breached their fiduciary duties to the limited partners by among other things:

(a) LOFTSGAARDEN and ALOTEL INCORPORATED, acting on behalf of Alotel Associates, exe-

cuted a contract with 2361 for the construction of the motel building. Said contract permitted 2361 to derive a construction fee which was in excess of a fee comparable to and competitive with the fee of disinterested persons willing to render comparable services.

(b) LOFTSGAARDEN, individually or as President and sole or controlling shareholder of PDRC, earned commissions and profits from the various real estate transactions which culminated in the lease of the tracts of land on which the Rochester Ramada was to be built and operated to Alotel Associates.

(c) LOFTSGAARDEN and ALOTEL INCORPORATED failed to require 2361 to remedy the defects in 2361's construction of the Rochester Ramada, including, but not limited to, deficiencies in the air-conditioning/heating system and leaks in the roof and walls.

(d) LOFTSGAARDEN and ALOTEL INCORPORATED failed to properly account for partnership funds in that they permitted the cost of constructing the Rochester Ramada to be charged to Alotel Associates as operating costs and made payments of interest from partnership funds for debts incurred by entities other than Alotel Associates for projects unrelated to the activities of Alotel Associates.

(e) LOFTSGAARDEN and ALOTEL INCORPORATED failed to close the permanent financing in a timely fashion. Said failure to close resulted in additional interest costs to Alotel Associates.

(f) LOFTSGAARDEN and ALOTEL INCORPORATED failed to maintain financial records sufficient to permit NEUMANN, ANDERSON and AUSTIN to ascertain the mismanagement and breaches of fiduciary duty by LOFTSGAARDEN and Alotel Associates.

(g) LOFTSGAARDEN, as President and sole or controlling stockholder of PDRC, usurped Alotel

Associates' opportunity to lease the tracts of land on which the Rochester Ramada was to be built and operated from Alvin A. Holasek and Ward E. Holasek for Thirty-seven Thousand Two Hundred ($37,200) Dollars per year. Alotel Associates was then required to lease the tracts of land from PDRC for Seventy Thousand Two Hundred ($70,200) Dollars per year.

56. By virtue of LOFTSGAARDEN's and ALOTEL INCORPORATED's breaches of their fiduciary duties to NEUMANN, NEUMANN was damaged in the amount of Sixty-five Thousand Two Hundred Fifty ($65,250) Dollars.

57. By virtue of LOFTSGAARDEN's and ALOTEL INCORPORATED's breaches of their fiduciary duties to ANDERSON, ANDERSON was damaged in the amount of Forty-three Thousand Five Hundred ($43,500) Dollars.

58. By virtue of LOFTSGAARDEN's and ALOTEL INCORPORATED's breaches of their fiduciary duties to AUSTIN, AUSTIN was damaged in the amount of Forty-three Thousand Five Hundred ($43,500) Dollars.

COUNT FIVE

59. Plaintiffs NEUMANN, ANDERSON and AUSTIN reallege all of the allegations contained in Paragraphs 1 through 58 herein and incorporate the same by reference as if set forth in full herein.

60. LOFTSGAARDEN and ALOTEL INCORPORATED either had knowledge, or pursuant to reasonable investigation, should have had knowledge that their statements were untrue and that the facts which they omitted were necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.

61. Said untrue statements and omissions concerned material facts. NEUMANN, ANDERSON and AUSTIN each relied on the misrepresentations and omissions made by LOFTSGAARDEN and ALOTEL INCORPORATED.

62. By reason of the misrepresentations and omissions by LOFTSGAARDEN and ALOTEL INCORPORATED, NEUMANN, ANDERSON and AUSTIN have been damaged as set forth in Counts One through Four.

COUNT SIX

63. Plaintiffs NEUMANN, ANDERSON and AUSTIN reallege all of the allegations contained in Paragraphs 1 through 62 herein and incorporate the same by reference as if set forth in full herein.

64. Defendants NOAH, BURG, COULT and DUNLAP exercised control over ALOTEL INCORPORATED.

65. Pursuant to Section 15 of the Securities Act of 1933, 15 U.S.C. § 77, and Section 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78t(a), NOAH, BURG, COULT and DUNLAP are liable jointly and severally with ALOTEL INCORPORATED for ALOTEL INCORPORATED's violations of Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 of the Securities Exchange Commission, as set forth in Counts One and Two herein.

COUNT SEVEN

66. Plaintiffs NEUMANN, ANDERSON and AUSTIN reallege all of the allegations contained in Paragraphs 1 through 65 herein and incorporate the same by reference as if set forth in full herein.

67. Defendants NOAH, BURG, COULT and DUNLAP controlled ALOTEL INCORPORATED.

68. Pursuant to Minn. Stat. § 80A.23, subd. 3, NOAH, BURG, COULT and DUNLAP are liable jointly and severally with ALOTEL INCORPORATED for ALOTEL INCORPORATED's violations of Minn. Stat. §§ 80A.01 and 80A.03, as set forth in Count Three herein.

COUNT EIGHT

69. Plaintiffs NEUMANN, ANDERSON and AUSTIN reallege all of the allegations contained in Paragraphs 1 through 72 herein and incorporate the same by reference as if set forth in full herein.

70. TOUCHE ROSS either did not believe, or pursuant to reasonable investigation, should not have believed that its estimates of income, expenses, cash flow and tax consequences of projected operations of the Rochester Ramada, which it knew or should have known would be used to induce persons to purchase limited partnership units in Alotel Associates, were reliable.

71. Said forecast was not reliable in that:

(a) The information provided to TOUCHE ROSS, upon which TOUCHE ROSS based its conclusion that the experience of certain other Ramada Inn projects could be considered comparable to the proposed Rochester Ramada was an inadequate basis upon which to rest such a conclusion.

(b) Project expenses were grossly understated.

(c) Projected operating income and cash flow were grossly overstated.

72. TOUCHE ROSS either had knowledge, or pursuant to reasonable investigation, should have had knowl-

edge, that said forecast was to be included in the Offering Memorandum.

73. NEUMANN, ANDERSON and AUSTIN relied on the forecast prepared and supplied by TOUCHE ROSS to LOFTSGAARDEN and ALOTEL INCORPORATED.

74. Said forecast constitutes a violation of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 of the Securities Exchange Commission, 17 C.F.R. § 240.10b-5.

75. By virtue of TOUCHE ROSS' violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 of the Securities Exchange Commission, NEUMANN, ANDERSON and AUSTIN have been damaged as set forth in Counts One through Five.

COUNT NINE

76. Plaintiffs NEUMANN, ANDERSON and AUSTIN reallege all of the allegations contained in Paragraphs 1 through 75 herein and incorporate the same by reference.

77. The conduct of Defendants toward Plaintiffs NEUMANN, ANDERSON and AUSTIN, including, but not limited to misrepresentations and omissions, the management of Alotel Associates and the Ramada Inn construction and operations, and the provision of financial data, as described in Paragraphs 1 through 75 herein, was negligent.

78. As a direct and proximate result of Defendants' said negligence, Plaintiffs have been damaged as alleged in Counts One through Eight.

COUNT TEN

79. Plaintiffs NEUMANN, ANDERSON and AUSTIN reallege all of the allegations contained in Paragraphs 1 through 78 herein and incorporate the same by reference as it set forth in full herein.

80. LOFTSGAARDEN's conduct was willful, wanton and malicious.

81. By virtue of LOFTSGAARDEN's willful, wanton and malicious conduct, NEUMANN, ANDERSON and AUSTIN are entitled to punitive damages at least in the amount of Two Hundred Thousand ($200,000) Dollars.

WHEREFORE, Plaintiffs NEUMANN, ANDERSON and AUSTIN pray for judgment as follows:

1. Against Defendants ALOTEL INCORPORATED, M. S. NOAH, JOHN H. BURG, LYMAN H. COULT, ROBERT R. DUNLAP, PROPERTY DEVELOPMENT & RESEARCH COMPANY, 2361 BUILDING CORPORATION and TOUCHE ROSS & COMPANY, and each of them, judgment for Plaintiff NEUMANN, in the amount of Sixty-five Thousand Two Hundred Fifty ($65,250) Dollars, together with interest thereon, reasonable attorneys' fees, and costs and disbursements.

2. Against Defendants ALOTEL INCORPORATED, M. S. NOAH, JOHN H. BURG, LYMAN H. COULT, ROBERT R. DUNLAP, PROPERTY DEVELOPMENT & RESEARCH COMPANY, 2361 BUILDING CORPORATION and TOUCHE ROSS & COMPANY, and each of them, judgment for Plaintiff ANDERSON, in the amount of Forty-three Thousand Five Hundred ($43,500) Dollars, together with interest thereon, reasonable attorneys' fees, and costs and disbursements herein.

3. Against Defendants ALOTEL INCORPORATED, M. S. NOAH, JOHN H. BURG, LYMAN H. COULT, ROBERT R. DUNLAP, PROPERTY DEVELOPMENT & RESEARCH COMPANY, 2361 BUILDING CORPORATION and TOUCHE ROSS & COMPANY, and each of them, judgment for Plaintiff AUSTIN, in the amount of Forty-three Thousand Five Hundred ($43,500) Dollars, together with interest thereon, reasonable attorneys' fees, and costs and disbursements herein.

4. Against Defendant B. J. LOFTSGAARDEN, judgment for Plaintiff NEUMANN, in the amount of Sixty-five Thousand Two Hundred Fifty ($65,250) Dollars, together with interest thereon, punitive damages in a reasonable amount, reasonable attorneys' fees, and costs and disbursements herein.

5. Against Defendant B. J. LOFTSGAARDEN, judgment for Plaintiff ANDERSON, in the amount of Forty-three Thousand Five Hundred ($43,500) Dollars, together with interest thereon, punitive damages in a reasonable amount, reasonable attorneys' fees, and costs and disbursements herein.

6. Against Defendant B. J. LOFTSGAARDEN, judgment for Plaintiff AUSTIN, in the amount of Forty-three Thousand Five Hundred ($43,500) Dollars, together with interest thereon, punitive damages in a reasonable amount, reasonable attorneys' fees, and costs and disbursements herein.

7. Such other relief as the Court may deem just and appropriate.

DATED: June 12, 1980.

FREDRIKSON, BYRON,
COLBORN, BISBEE &
HANSEN, P.A.

By /s/ Terence M. Fruth

By /s/ John A. Grimstad

4744 IDS Center
Minneapolis, MN 55402
(612) 339-8331

Attorneys for Plaintiffs:

Dr. Myrel A. Neumann

Dr. Thomas W. Anderson

Dr. Roger E. Austin

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA
FOURTH DIVISION

JOINT & SEPARATE ANSWER AND COUNTERCLAIM OF DEFENDANTS TO THE THIRD AMENDED AND SEPARATE COMPLAINT OF PLAINTIFF RANDALL.

Filed June 16, 1980

[Title Omitted in Printing]

The defendants above-named, for their Answer to the Third Amended and Separate Complaint of Dr. William C. Randall, state:

1. Deny the allegations set forth in paragraphs 1 and 2.

2. Admit the allegations set forth in paragraph 3.

3. Admit the allegations set forth in paragraph 4, except as to plaintiff, John S. Hall, which allegation is denied.

4. Admit that B. J Loftsgaarden is a citizen and resident of Minnesota and that B. J. Loftsgaarden organized Alotel Associates for the purpose of building, furnishing and operating a motel in Rochester, Minnesota, to be known as the Rochester Ramada, but deny each and every other allegation set forth in paragraph 5.

5. Admit the allegations set forth in paragraph 6, except as to the effective date upon which Alotel, Incorporated ceased to act as a general partner of Alotel Associates, which allegation is denied.

6. Admit the allegations set forth in paragraph 7.

7. Deny the allegations set forth in paragraph 8.

8. Admit the allegations set forth in paragraphs 9 and 10.

9. Admit the allegations set forth in paragraph 11, except to the extent that such allegations modify or vary the written forecast prepared by Touche Ross & Co. and made a part of the offering memorandum.

10. Admit the allegations set forth in paragraph 12, except as to the allegations that Loftsgaarden and Alotel, Incorporated made certain oral representations concerning Alotel Associates to Randall, which allegations are denied.

11. Admit the allegations set forth in paragraph 13, except as to the allegations that Loftsgaarden and Alotel Incorporated made oral representations of a nature similar to those made to Randall to the other above-named plaintiffs, which allegations are denied.

12. Deny the allegations set forth in paragraphs 14 and 15.

13. Admit that Randall subscribed to and purchased one limited partnership unit in Alotel Associates for the sum of $35,000, but deny each and every other allegation set forth in paragraph 16.

14. Admit the allegations set forth in paragraph 17, except as to plaintiff, John S. Hall, which allegation is denied.

15. Admit that Alotel Associates experienced cash flow problems in March, 1975, but deny each and every other allegation set forth in paragraph 18.

16. Deny the allegations set forth in paragraphs 19 and 20.

17. Lack information or knowledge sufficient to form a belief as to the truth of the allegation set forth in paragraph 21.

18. Admit that Alotel Associates was experiencing cash flow problems in May, 1975, but deny each and every other allegation set forth in paragraph 22.

19. Deny the allegations set forth in paragraphs 23 and 24.

20. Lack information or knowledge sufficient to form a belief as to the truth of the allegations set forth in paragraph 24a.

21. Deny the allegations set forth in paragraph 24b.

22. Lack information or knowledge sufficient to form a belief as to the truth of the allegations set forth in paragraph 25.

23. Admit or deny, as stated above in paragraphs 1 to 22 of this Answer, the allegations contained in paragraphs 1 to 25 of the Complaint as realleged in paragraph 26 of the Complaint.

24. Deny the allegations set forth in paragraphs 27, 28, 28a, 28b, 29, 30, 30a, 30b, 30c, 30d, and 31.

AS TO COUNT TWO:

25. Admit or deny, as stated above in paragraphs 1 to 24 of this Answer, the allegations contained in paragraphs 1 to 31 of the Complaint as realleged in paragraph 32 of the Complaint.

26. Deny the allegations set forth in paragraphs 33 and 34.

AS TO COUNT THREE:

27. Admit or deny, as stated above in paragraphs 1 to 26 of this Answer, the allegations set forth in paragraphs 1 to 34 of the Complaint as realleged in paragraph 35 of the Complaint.

28. Deny the allegations set forth in paragraphs 36 and 37.

AS TO COUNT FOUR:

29. Admit or deny, as stated above in paragraphs 1 to 28 of this Answer, the allegations contained in paragraphs 1 to 37 of the Complaint as realleged in paragraph 38 of the Complaint.

30. Deny the allegations set forth in paragraphs 39 and 40.

AS TO COUNT FIVE:

31. Admit or deny, as stated above in paragraphs 1 to 30 of this Answer, the allegations set forth in paragraphs 1 to 40 of the Complaint as realleged in paragraph 41 of the Complaint.

32. Deny the allegations set forth in paragraphs 42, 43, and 44.

AS TO COUNT SIX:

33. Admit or deny, as stated above in paragraphs 1 to 32 of this Answer, the allegations set forth in paragraphs 1 to 44 of the Complaint as realleged in paragraph 45 of the Complaint.

34. Deny the allegations set forth in paragraphs 46, 47 and 48.

AS TO COUNT SEVEN:

35. Admit or deny, as stated above in paragraphs 1 to 34 of this Answer, the allegations set forth in paragraphs 1 to 48 of the Complaint as realleged in paragraph 49 of the Complaint.

36. Deny the allegations set forth in paragraphs 50 and 51.

AS TO COUNT EIGHT:

37. Admit or deny, as stated above in paragraphs 1 to 36 of this Answer, the allegations set forth in paragraphs 1 to 51 of the Complaint as realleged in paragraph 52 of the Complaint.

38. Deny the allegations set forth in paragraphs 53 and 54.

AS TO COUNT NINE:

39. Admit or deny, as stated above in paragraphs 1 to 38 of this Answer, the allegations set forth in paragraphs 1 to 54 of the Complaint as realleged in paragraph 55 of the Complaint.

40. Lack information or knowledge sufficient to form a belief as to the truth of the allegations set forth in paragraph 56.

41. Deny the allegations set forth in paragraph 58.

43. Deny the allegations set forth in paragraphs 59, 60 and 61.

AS TO COUNT TEN:

44. Admit or deny, as stated above in paragraphs 1 to 43 of this Answer, the allegations set forth in para-

graphs 1 to 61 of the Complaint as realleged in paragraph 61a of the Complaint.

45. Deny the allegations set forth in paragraphs 61b and 61c.

AS TO COUNT ELEVEN:

46. Admit or deny, as stated above in paragraphs 1 to 45 of this Answer, the allegations set forth in paragraphs 1 through 61 of the Complaint as realleged in paragraph 62 of the Complaint.

47. Deny the allegations set forth in paragraph 63 and 64.

AFFIRMATIVE DEFENSES

48. The Complaint fails to state the claim upon which relief may be granted.

49. The Court lacks jurisdiction over the subject matter.

50. The Court lacks jurisdiction over the person of one or more of the defendants.

51. Defendants have fully performed all the terms and conditions of that certain stipulation of settlement and settlement agreement entered into between defendants and Alotel Associates, on its own behalf and on behalf of all plaintiffs, including Dr. William C. Randall, now on file and of record on that certain consolidated action in the District Court, Third Judicial District, County of Olmsted, State of Minnesota, entitled the *First National Bank of Rochester v. Property Development and Research Company, et al,* File No. 40449, and *United Realty Trust v. Property Development and Research Company, et al,*

File No. 40375, and plaintiff received and accepted the same in full satisfaction and discharge of any and all claims which he has or may have for damages purportedly sustained by plaintiff by reason of the acts alleged in his separate complaint.

52. Plaintiff had knowledge of and assumed the risks incident to his purchase of a limited partnership unit in Alotel Associates and the damages alleged by plaintiff were caused by and arose of such risks.

53. Whatever damages were sustained by plaintiff as a result of his purchase of a limited partnership unit in Alotel Associates were caused in whole or in part, or contributed to by reason of the negligent acts or omissions of plaintiff.

54. Plaintiff lacks standing to pursue the claims asserted in his separate complaint by reason of his active involvement in the management and conduct of the affairs of Alotel Associates and the operation of the Rochester Ramada.

55. Plaintiff is estopped, by reason of his assumption, together with the assumption by all other plaintiffs in this action, of the duties of the general partner of Alotel Associates and the subsequent stipulation of settlement and settlement agreement alleged above, from asserting the claims set forth in his separate complaint.

56. On information and belief, plaintiff fraudulently induced defendants to sell to him a limited partnership unit of Alotel Associates by misrepresentation of his suitability as an investor in Alotel Associates in accordance with the standards set forth in the Offering Memorandum.

57. Plaintiff, together with all other individual plaintiffs in this action who purchased limited partnership units of Alotel Associates, delivered to defendants for valuable consideration a general release contained in the stipulation of settlement and settlement agreement whereby plaintiff duly released defendants or forever discharged them from any and all claims arising out of or related to his investment in Alotel Associates as a Limited Partner, including the claims alleged in his separate complaint.

58. Plaintiff's claims are barred by various applicable statutes of limitations.

59. Defendants B. J. Loftsgaarden and Alotel Incorporated's performance as general partners of Alotel Associates, the failure of which is alleged in the separate complaint, was made impossible by various intervening forces over which the defendants had no control, including their removal as general partners of Alotel Associates and unfavorable economic conditions.

COUNTERCLAIM

Defendants B. J. Loftsgaarden and Alotel, Inc., for their separate counterclaim against plaintiff, William C. Randall, state:

JURISDICTION

Subject matter jurisdiction is based upon the pendent jurisdiction of this Court and the matter in controversy exceeds the sum of $10,000, exclusive of interests and costs.

COUNT ONE

60. Defendants reallege each allegation of the separate complaint of William C. Randall which has been admitted by defendants as stated above in paragraphs 1 to 59 of their Answer.

61. On or about November 13, 1973 plaintiff purchased one limited partnership unit in Alotel Associates, a limited partnership duly organized under the laws of the State of Minnesota.

62. Prior to purchasing the said limited partnership unit, plaintiff represented to defendants that he was suitable as an investor in Alotel Associates and that he complied with the investor's suitability standards set forth in the offering memorandum, i.e., plaintiff represented that he had a net worth in excess of $200,000 (excluding home and automobiles) or that some portion of his income was subject to state and federal income taxes at a rate of 50% or more.

63. On information and belief, the foregoing representations made by plaintiff as to his suitability as an investor in Alotel Associates were false.

64. In reliance upon said misrepresentations, defendants sold one limited partnership unit to plaintiff for the consideration of $35,000.00.

65. During the course of development, construction and operation of the Ramada Inn project by Alotel Associates, plaintiff interfered with and otherwise obstructed management and conduct of the affairs of Alotel Associates and the performance and discharge of the duties and obligations of defendants as general partners of Alotel

Associates. Such acts of interference and obstruction of the development, construction and operation of the Ramada Inn project by Alotel Associates and the performance and discharge of the various duties and obligations of defendants as general partners were caused by plaintiff's unsuitability as an investor and were committed by plaintiff with malice aforethought and with the intent to injure and otherwise harm defendants.

66. As a result of the foregoing acts and omissions of plaintiff, defendants incurred additional liabilities and suffered other damages, including the loss of contracts, in connection with their investment in Alotel Associates as the developer of the Ramada Inn project and as the general partners of Alotel Associates.

67. As a result of the foregoing, defendants are entitled to compensatory damages in the sum of $200,000 and punitive damages in the sum of $500,000.00.

COUNT TWO

68. Paragraphs 60 and 67 of Count One of this Counterclaim are re-alleged in their entirety.

69. During the summer of 1975 and, in no event, later than September 17, 1975, plaintiff became actively involved in and assumed responsibility for the daily operation and management of the Ramada Inn project owned by Alotel Associates and the conduct of the general affairs of Alotel Associates. During such period of time, and at the instigation and insistence of plaintiff, defendants were removed as general partners of Alotel Associates and ceased all active involvement in the management and operation of the Ramada Inn project.

70. By reason of their involvement in the development, construction and operation of the Ramada Inn project for Alotel Associates, defendants invested substantial amounts of money and time and thereby conferred substantial benefits upon Alotel Associates for which defendants are entitled to be compensated.

71. Plaintiff knew or should have known that defendants had conferred substantial benefits upon Alotel Associates for which they are entitled to compensation.

72. Plaintiff negligently and recklessly, and with wanton disregard of defendants' rights as developer and former general partners of Alotel Associates, managed the affairs of and operated the Ramada Inn project in such a manner as to waste the assets of Alotel Associates, lose substantial profits in the Ramada Inn project, and ultimately place the entire Ramada Inn project in default, whereupon foreclosure proceedings were commenced and the project taken over by the project's permanent lenders, including, but not limited to the First National Bank of Rochester and United Realty Trust.

73. As a result of the foregoing negligent acts and omission of plaintiffs, defendants were damaged in the sum of not less than $200,000.00.

COUNT THREE

74. On or about December 20, 1976, defendants and plaintiff entered into an agreement whereby defendants agreed to dismiss that certain unlawful detainer action then pending in Olmsted County Court, State of Minnesota, and to perform certain other duties and acts, in consideration for which Alotel Associates and each of

its individual partners, including plaintiff, agreed to release and forever discharge defendants from any and all claims which they had or may have had, now or in the future, arising out of or related to their investments in Alotel Associates and that certain project known as the Rochester Ramada Inn, including the claims asserted by plaintiff in this action.

75. Defendants, and each of them, fully performed each and every term and condition of such agreement required on its part, including the payment of monies to various creditors of Alotel Associates and the conveyance of any and all interests which defendants had or may have had in the Rochester Ramada Inn and the real property upon which it is situated to Alotel Associates for its benefit and for the benefit of its individual partners, including plaintiff.

76. Defendants performed such terms and conditions on its part in reliance upon the promises of Alotel Associates and its individual partners, including plaintiff, to fully perform the terms and conditions required by such agreement on their part, including without limitation the full and final release and discharge of defendants from all claims and causes of action as alleged above.

77. Plaintiff has refused and otherwise failed to perform on its part such terms and conditions and has breached said agreement.

78. As a result of plaintiff's breach of said agreement, defendants have been damaged in an amount not less than $120,000, including attorneys' fees necessarily incurred as a result of such breach.

WHEREFORE, the defendants demand judgment against plaintiff as follows:

1. Dismissing with prejudice the Separate Complaint of William C. Randall;

2. Awarding to defendants B. J. Loftsgaarden and Alotel, Inc. compensatory damages in the amount of $200,000.00;

3. Awarding to defendants B. J. Loftsgaarden and Alotel, Inc. damages in the amount of $120,000.00;

4. Awarding to defendants B. J. Loftsgaarden and Alotel, Inc. punitive damages in the amount of $500,000;

5. Awarding to defendants their costs and disbursements, including attorneys' fees; and

6. Granting to defendants such other and further relief as the court deems just and equitable.

MEAGHER, GEER, MARKHAM,
ANDERSON, ADAMSON,
FLASKAMP & BRENNAN

By /s/ Clyde F. Anderson
Attorneys for Defendants
2250 IDS Center
Minneapolis, MN 55402
(612) 338-0661

June 13, 1980.

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA
FOURTH DIVISION

JOINT AND SEPARATE ANSWERS AND COUNTERCLAIMS OF DEFENDANTS TO SECOND AMENDED AND SEPARATE COMPLAINTS OF PLAINTIFFS NEUMANN, ANDERSON, AND AUSTIN.

Filed June 16, 1980

[Title Omitted in Printing]

Come now these answering defendants and for their Joint and Separate Answer to Plaintiffs Neumann, Anderson and Austin's Second Amended and Separate Complaint:

1. Deny generally each and every allegation, statement and other thing in said Complaint contained except as hereinafter admitted, qualified or otherwise answered.

2. Deny the allegations set forth in paragraphs 1 and 2.

3. Admit the allegations set forth in paragraph 3.

4. Admit the allegations set forth in paragraph 4 except as to plaintiff John S. Hall, which allegation is denied.

5. Admit that B. J. Loftsgaarden is a citizen and resident of Minnesota and that B. J. Loftsgaarden organized Alotel Associates for the purpose of building, furnishing and operating a motel in Rochester, Minnesota to be known as the Rochester Ramada, but deny each and every other allegation set forth in paragraph 5.

6. Admit the allegations set forth in paragraph 6 except as to the effective date upon which Alotel Incorporated ceased to act as a general partner of Alotel Associates, which allegation is denied.

7. Admit the allegations set forth in paragraph 7.

8. Deny the allegations set forth in paragraph 8.

9. Admit the allegations set forth in paragraphs 9 and 10.

10. Admit the allegations set forth in paragraph 11 except to the extent that such allegations modify or vary the written forecast prepared by Touche Ross & Company and made a part of the offering memorandum.

11. Admit that Loftsgaarden and Alotel, Incorporated supplied an offering memorandum concerning Alotel Associates to plaintiffs Neumann and Anderson and Austin and that the offering memorandum contained the estimates supplied by Touche Ross, deny the last sentence of paragraph 12.

12. Admit the first sentence of paragraph 13. Deny the allegation of oral representations.

13. Deny the allegations set forth in paragraph 14 and 15.

14. In regard to paragraphs 16, 17, and 18, admits that Plaintiff Neumann purchased one and a half partnership units, Plaintiff Anderson purchased one unit and Plaintiff Austin purchased one unit.

15. Admit the allegations set forth in paragraph 19 except as to plaintiff John S. Hall which allegation is denied.

16. With respect to paragraphs 20, 21. and 22, admit that Alotel Associates experienced cash flow problems in March. 1975, but deny each and every other allegation set forth in those paragraphs.

17. Deny the allegations set forth in paragraphs 23 and 24.

18. Lack information or knowledge sufficient to form a belief as to the truth of the allegations set forth in paragraph 25.

19. Admit that Alotel Associates was experiencing cash flow problems in May of 1975, but deny each and every other allegation set forth in paragraphs 26, 27, and 28.

20. Deny the allegations set forth in paragraphs 29 and 30.

21. Lack information or knowledge sufficient to form a belief in regard to paragraph 31.

22. Deny the allegations set forth in paragraph 32.

23. Lack information or knowledge sufficient to form a belief in regard to paragraph 33.

AS TO COUNT ONE:

24. Admit or deny, as stated above in paragraphs 1 to 21 of this Answer, the allegations contained in paragraphs 1 to 33 of the Complaint as realleged in paragraph 34 of the Complaint.

25. Deny the allegations set forth in paragraphs 35 to 45.

AS TO COUNT TWO:

26. Admit or deny, as stated above in paragraphs 1 to 25 of this Answer, the allegations contained in paragraphs 1 to 42 of the Complaint as realleged in paragraph 46 of the Complaint.

27. Deny the allegations set forth in paragraphs 46 and 50.

AS TO COUNT THREE:

28. Admit or deny, as stated above in paragraphs 1 to 27 of this Answer, the allegations set forth in paragraphs 1 to 47 of the Complaint as realleged in paragraph 51 of the Complaint.

29. Deny the allegations set forth in paragraphs 52 and 53.

AS TO COUNT FOUR:

30. Admit or deny, as stated above in paragraphs 1 to 29 of this Answer, the allegations contained in paragraphs 1 to 53 of the Complaint as realleged in paragraph 54 of the Complaint.

31. Deny the allegations set forth in paragraphs 55 and 56.

AS TO COUNT FIVE:

32. Admit or deny as stated above in paragraphs 1 to 31 of this Answer, the allegations set forth in paragraphs 1 to 56 of the Complaint as realleged in paragraph 57 of the Complaint.

33. Deny the allegations set forth in paragraphs 58 through 62.

AS TO COUNT SIX:

34. Admit or deny, as stated above in paragraphs 1 to 33 of this Answer, the allegations set forth in paragraphs 1 to 62 of the Complaint as realleged in paragraph 63 of the Complaint.

35. Deny the allegations set forth in paragraphs 64 to 66.

AS TO COUNT SEVEN:

36. Admit or deny, as stated above in paragraphs 1 to 35 of this Answer, the allegations set forth in paragraphs 1 to 66 of the Complaint as realleged in paragraph 67 of the Complaint.

37. Deny the allegations set forth in paragraphs 68 and 69.

AS TO COUNT EIGHT:

38. Admit or deny, as stated above in paragraphs 1 to 37 of this Answer, the allegations set forth in paragraphs 1 to 69 of the Complaint as realleged in paragraph 70 of the Complaint.

39. Deny the allegations set forth in paragraphs 71 and 72.

AS TO COUNT NINE:

40. Admit or deny, as stated above in paragraphs 1 to 39 of this Answer, the allegations set forth in paragraphs 1 to 72 of the Complaint as realleged in paragraph 73 of the Complaint.

41. Lack information or knowledge sufficient to form a belief as to the truth of the allegations set forth in paragraph 74.

42. Deny the allegations set forth in paragraph 75.

43. Admit the allegations set forth in paragraph 76.

44. Deny the allegations set forth in paragraphs 77, 78, and 79.

AS TO COUNT TEN:

45. Admit or deny, as stated above in paragraphs 1 to 44 of this Answer, the allegations set forth in paragraphs 1 through 79 of the Complaint as realleged in paragraph 80 of the Complaint.

46. Deny the allegations set forth in paragraphs 81 and 82.

AS TO COUNT ELEVEN:

47. Admit or deny, as stated above in paragraph 1 to 46 of this Answer, the allegations set forth in paragraphs 1 through 82 of the Complaint as realleged in paragraph 83 of the Complaint.

48. Deny the allegations set forth in paragraphs 84 and 85.

AFFIRMATIVE DEFENSES

49. The Complaint fails to state a claim upon which relief may be granted.

50. The Court lacks jurisdiction over the subject matter.

51. The Court lacks jurisdiction over the person of one or more of the defendants.

52. Defendants have fully performed all the terms and conditions of that certain stipulation of settlement and settlement agreement entered into between defendants and Alotel Associates, on its own behalf and on behalf of all plaintiffs, including Doctors Neumann, Anderson and Austin, now on file and of record on that certain consolidated action in the District Court, Third Judicial District, County of Olmsted, State of Minnesota, entitled the *First National Bank of Rochester v. Property Development and Research Company, et al,* File No. 40449, and *United Realty Trust v. Property Development and Research Company, et al,* 40375, and plaintiffs received and accepted the same in full satisfaction and discharge of any and all claims which they have or may have for damages purportedly sustained by plaintiffs by reason of the alleged acts in their separate complaint.

53. Plaintiffs had knowledge of and assumed the risks incident to their purchase of limited partnership units in Alotel Associates and the damages alleged by plaintiffs were caused by and arose out of such risks.

54. Whatever damages were sustained by plaintiffs as a result of their purchase of limited partnership units in Alotel Associates were caused in whole, or in part, or contributed to, by reason of the negligent acts or omissions of the plaintiffs and each of them.

55. Plaintiffs, and each of them, lack standing to pursue the claims asserted in their separate Complaint by reason of their active involvement in the management and conduct of the affairs of Alotel Associates and the operation of the Rochester Ramada.

56. Plaintiffs are estopped, by reason of their assumption, together with the assumption by all other plaintiffs in this action, of the duties of the general partner of Alotel Associates and the subsequent stipulation of settlement and settlement agreement alleged above, from asserting the claims set forth in their separate Complaint.

57. Plaintiffs, together with all other individual plaintiffs in this action who purchased limited partnership units of Alotel Associates, delivered to defendants for valuable consideration a general release contained in the stipulation of settlement and settlement agreement whereby plaintiff duly released defendants or forever discharged them from any and all claims arising out of or related to their investment in Alotel Associates as limited partners including the claims alleged in their separate Complaint.

58. Plaintiffs' claims, in whole or in part, are barred by various applicable statutes of limitations.

59. Defendants B. J. Loftsgaarden and Alotel Incorporated's performance as general partners of Alotel Associates, the failure of which is alleged in the separate Complaint, was made impossible by various intervening forces over which the defendants had no control, including their removal as general partners of Alotel Associates and unfavorable economic conditions.

COUNTERCLAIM

Defendants B. J. Loftsgaarden and Alotel Incorporated, for their separate Counterclaim against plaintiffs Neumann, Anderson, and Austin, and each of them, state:

JURISDICTION

Subject matter jurisdiction is based upon the pendent jurisdiction of this Court and the matter in controversy exceeds the sum of $10,000, exclusive of interests and costs.

COUNT ONE

60. Defendants reallege each allegation of the separate Complaint of Plaintiffs Neumann, Anderson and Austin which has been admitted by these defendants as stated above in paragraphs 1 to 48 of this Answer.

61. During the summer of 1975, and in no event later than September 17, 1975, plaintiffs and each of them became actively involved in and assumed the responsibility for the daily operation and management of the Ramada Inn project owned by Alotel Associates and the conduct of the general affairs of Alotel Associates. During such period of time, and at the instigation and insistence of plaintiffs, defendants were removed as general partners of Alotel Associates and ceased all active involvement in the management and operation of the Ramada Inn project.

62. By reason of their involvement in the development, construction and operation of the Ramada Inn project for Alotel Associates, defendants invested substantial amounts of money and time and thereby conferred substantial benefits upon Alotel Associates for which defendants are entitled to be compensated.

63. Plaintiffs knew, or should have known, that defendants had conferred substantial benefits upon Alotel Associates for which they are entitled compensation.

64. Plaintiffs negligently and recklessly, with wanton disregard of defendants' rights as developer and former general partners of Alotel Associates, managed the affairs of and operated the Ramada Inn project in such a manner as to waste the assets of Alotel Associates, lose substantial profits in the Ramada Inn project, and ultimately place the entire Ramada Inn project in default, whereupon foreclosure proceedings were commenced and the project taken over by the project's permanent lenders, including, but not limited to, the First National Bank of Rochester and United Realty Trust.

65. As a result of the foregoing negligent acts and omissions of plaintiffs, defendants were damaged in the sum of not less than $200,000.00.

COUNT TWO

66. On or about December 20, 1976, defendants and plaintiffs entered into an agreement whereby defendants agreed to dismiss that certain unlawful detainer action then pending in Olmstead County Court, State of Minnesota, and to perform certain other duties and acts in consideration for which Alotel Associates and each of its individual partners, including plaintiffs, agreed to release and forever discharge defendants from any and all claims which they had or may have had, now or in the future, arising out of or related to their investments in Alotel Associates and that certain project known as the Rochester Ramada Inn, including the claims asserted by plaintiffs in this action.

67. Defendants, and each of them, fully performed each and every term and condition of such agreement re-

quired on its part, including the payment of monies to various creditors of Alotel Associates and the conveyance of any and all interests which defendants had or may have had in the Rochester Ramada Inn and the real property upon which it is situated to Alotel Associates for its benefit and for the benefit of its individual partners, including plaintiffs.

68. Defendants performed such terms and conditions on its part in reliance upon the promises of Alotel Associates and its individual partners, including plaintiffs, to fully perform the terms and conditions required by such agreement on their part. including without limitation the full and final release and discharge of defendants from all claims and causes of action as alleged above.

69. Plaintiffs have refused and otherwise failed to perform on their part such terms and conditions and have breached their agreement.

70. As a result of plaintiffs' breach of said agreement, defendants have been damaged in an amount not less than $120,000, including attorneys' fees necessarily incurred as a result of said breach.

WHEREFORE, the defendants demand judgment against plaintiffs as follows:

1. Dismissing with prejudice the separate Complaint of Plaintiffs Neumann, Anderson and Austin.

2. Awarding to defendants B. J. Loftsgaarden and Alotel Inc., compensatory damages in the amount of $200,000.00.

3. Awarding to defendants B. J. Loftsgaarden and Alotel Inc., damages in the amount of $120,000.00.

4. Awarding to defendants their costs and disbursements including attorneys' fees; and

5. Granting to defendants such other and further relief as the Court deems just and equitable.

MEAGHER, GEER, MARKHAM,
ANDERSON, ADAMSON,
FLASKAMP & BRENNAN

By /s/ Clyde F. Anderson
Attorneys for Defendants
2250 IDS Center
Minneapolis, MN 55402
(612) 338-0661

June 13, 1980.

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA
FOURTH DIVISION

Defendants' Requested Jury Instruction No. 30

Filed June 26, 1980

[Title Omitted in Printing]

REQUEST NO. 30

FIFTH ELEMENT: CAUSATION/DAMAGES

In order to recover in this case, each plaintiff must prove by a fair preponderance of the evidence that he suffered damages as a proximate result of the alleged false and misleading statements or omissions and the investment of money in Alotel Associates in reliance on them. This element has two parts: first, it requires a finding that the plaintiffs suffered damages; and second, it requires a finding that those damages were proximately caused by the defendants' conduct, and not by other factors.

a. *Existence of Damages*

First you must determine that the plaintiffs suffered actual damages as the result of their investment in Alotel Associates. In making this determination, you are instructed that you may consider that money which the plaintiffs actually invested in the partnership, both for the purchase of limited partnership units and for the later advancement of additional money to the partnership. You may then consider what part of their investment the plaintiffs have already recovered, either in the form of returns on their investment or in the form of income tax benefits which they have obtained.

See Devitt and Blackmar, *Federal Jury Practice and Instructions* § 98.14: *Dupuy v. Dupuy*, 551 F.2d 1005, 1025 (5th Cir. 1977); *Bridgen v. Scott*, 456 F.Supp. 1048, 1058-1059, 1061 (S.D. Tex. 1978); *Bayoud v. Ballard*, 404 F.Supp. 417, 426 (D. Tex. 1975); *Hickman v. Groesbeck* 389 F.Supp. 769, 780 (D. Utah 1974).

b. *Causation*

If you determine that any of the plaintiffs did suffer actual damages, you must then determine whether the alleged misleading statements or omissions of the defendants were the proximate cause of that loss. In order to recover, the plaintiffs must show that the alleged misleading statements or omissions of the defendants played a substantial part in bringing about or causing the damages suffered by them, and that the damages were either a direct result or a reasonably foreseeable result of the misleading statements or omissions. If you find that any loss sustained by the plaintiffs was caused by something other than the conduct of the defendants, then you must find for the defendants.

Devitt and Blackmar, *Federal Jury Practice and Instructions* § 98.14; *Investors Thrift Corp. v. Sexton*, 491 F.2d 768 (8th Cir. 1974).

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA
FOURTH DIVISION

SPECIAL VERDICT

Filed June 25, 1980

[Title Omitted in Printing]

Rule 10b-5 and Chapter 80A Claims

In connection with the sale of limited partnership units in Alotel Associates to plaintiffs:

1. Did the Offering Memorandum contain any untrue statement of material fact or omit to state a material fact necessary in order to make the statements contained therein not misleading?

Answer: Yes or No Yes

2. *If* and *only if* your answer to Question No. 1 is "Yes", answer the following question:

Was such untrue statement of material fact or omission knowingly made?

Answer: Yes or No Yes

3. *If* and *only if* your answers to to Question Nos. 1 and 2 are both "Yes", answer the following question:

Which, if any, of defendants is liable for such untrue statement or omission?

Filed June 25, 1980

Robert E. Hess, Clerk
By /s/ Sj
Deputy

Answer: Loftsgaarden —Yes or No Yes
Alotel Incorporated —Yes or No Yes
Noah —Yes or No No
Coult —Yes or No No
PDRC —Yes or No Yes
2361 —Yes or No Yes

4. *If* and *only if* your answers to both Question Nos. 1 and 2 are "Yes" *and if* and *only if* your answer to Question No. 3 included one or more answers of "Yes", answer the following question:

Which, if any, of plaintiffs relied on such untrue statement?

Answer: Dr. Anderson —Yes or No Yes
Dr. Austin —Yes or No Yes
Dr. Neumann —Yes or No Yes
Dr. Randall —Yes or No Yes

5. *If* and *only if* your answers to Questions Nos. 1 and 2 are "Yes" *and if* and *only if* your answer to Question No. 4 included one or more answers of "Yes", answer the following question with respect to each plaintiff as to whom your answer to Question No. 4 is "Yes":

Which, if any, of plaintiffs suffered damage as a result of such reliance?

Answer: Dr. Anderson —Yes or No Yes
Dr. Austin —Yes or No Yes
Dr. Neumann —Yes or No Yes
Dr. Randall —Yes or No Yes

In connection with plaintiffs' making of loans to Alotel Associates:

6. *If* and *only if* your answer to Question No. 4 included one or more answers of "Yes", answer the following question *only* with respect to each plaintiff as to whom your answer to Question No. 3 is "Yes":

Which if any, of plaintiffs continued to rely on an untrue statement or omission in the Offering Memorandum in making one or more loans to Alotel Associates?

Answer: Dr. Anderson —Loan # 1—Yes or No No
—Loan # 2—Yes or No No
—Loan # 3—Yes or No No
—Loan # 4—Yes or No No
—Loan # 5—Yes or No No

Dr. Austin —Loan # 1—Yes or No No
—Loan # 2—Yes or No No
—Loan # 3—Yes or No No
—Loan # 4—Yes or No No
—Loan # 5—Yes or No No

Dr. Neumann —Loan # 1—Yes or No No
—Loan # 2—Yes or No No
—Loan # 3—Yes or No No
—Loan # 4—Yes or No No
—Loan # 5—Yes or No No

Dr. Randall —Loan # 1—Yes or No No
—Loan # 2—Yes or No No
—Loan # 3—Yes or No No

7. *If* and *only if* you did *not* answer "Yes" to all portions of Question No. 6, answer the following question:

> Did defendants make any additional untrue statement of material fact or omit to state a material fact at or before the time plaintiffs made loans to Alotel Associates?

Answer: Yes or No Yes

8. *If* and *only if* you did *not* answer "Yes" to all portions of Question No. 6 *and if* and *only if* your answer to Question No. 7 was "Yes", answer the following question:

> Which, if any, of defendants is liable for such untrue statement or omission?

Answer:	Loftsgaarden	—Yes or No Yes
	Alotel Incorporated	—Yes or No Yes
	Noah	—Yes or No No
	Coult	—Yes or No No
	PDRC	—Yes or No Yes
	2361	—Yes or No Yes

9. *If* and *only if* your answer to Question No. 7 is "Yes" *and if* and *only if* your answer to Question No. 8 included one or more answers of "Yes", answer the following question *only* with respect to such loan as to which your answer to Question No. 6 was "No":

> Which, if any, of plaintiffs relied on such untrue statement in connection with the making of which, if any, loan?

Answer:	Dr. Anderson	—Loan # 1—Yes or No No
		—Loan # 2—Yes or No No

—Loan # 3—Yes or No No
—Loan # 4—Yes or No No
—Loan # 5—Yes or No No

Dr. Austin —Loan # 1—Yes or No No
—Loan # 2—Yes or No No
—Loan # 3—Yes or No No
—Loan # 4—Yes or No No
—Loan # 5—Yes or No No

Dr. Neumann —Loan # 1—Yes or No No
—Loan # 2—Yes or No No
—Loan # 3—Yes or No No
—Loan # 4—Yes or No No
—Loan # 5—Yes or No No

Dr. Randall —Loan # 1—Yes or No No
—Loan # 2—Yes or No No
—Loan # 3—Yes or No No

10. *If* and *only if* your answer to Question No. 9 included one or more answers of "Yes", answer the following question *only* with respect to such loan as to which your answer to Question No. 9 was "Yes":

Which, if any, of plaintiffs suffered damages as a result of such reliance?

Answer: Dr. Anderson —Loan # 1—Yes or No ——
—Loan # 2—Yes or No ——
—Loan # 3—Yes or No ——
—Loan # 4—Yes or No ——
—Loan # 5—Yes or No ——

Dr. Austin —Loan # 1—Yes or No ——
—Loan # 2—Yes or No ——
—Loan # 3—Yes or No ——
—Loan # 4—Yes or No ——
—Loan # 5—Yes or No ——

Dr. Neumann —Loan # 1—Yes or No ——
—Loan # 2—Yes or No ——
—Loan # 3—Yes or No ——
—Loan # 4—Yes or No ——
—Loan # 5—Yes or No ——

Dr. Randall —Loan # 1—Yes or No ——
—Loan # 2—Yes or No ——
—Loan # 3—Yes or No ——

Section 12(2) Claims

In connection with the sale of limited partnership units in Alotel Associates to plaintiffs:

11. Did the Offering Memorandum contain any untrue statement of material fact or omit to state a material fact necessary in order to make the statements made not misleading?

Answer: Yes or No Yes

12. *If* and *only if* your answer to Question No. 11 is "Yes", answer the following question:

Did defendants know or in the exercise of reasonable care should they have known that the untrue statement was false in that a material fact had been omitted?

Answer: Yes or No Yes

13. *If* and *only if* your answers to both Questions Nos. 11 and 12 are "Yes", answer the following question:

Which, if any, of plaintiffs did not know of the omitted fact or that the untrue statement was false?

Answer: Dr. Anderson —Yes or No Yes

Dr. Austin —Yes or No Yes

Dr. Neumann —Yes or No Yes

Dr. Randall —Yes or No Yes

14. *If* and *only if* your answer to Question No. 13 included one or more answers of "Yes", answer the following question *only* with respect to each plaintiff as to whom your answer to Question No. 10 was "Yes":

Which, if any, of plaintiffs continued to rely on an untrue statement or omission in the Offering Memorandum in making which, if any, loan to Alotel Associates?

Answer: Dr. Anderson —Loan # 1—Yes or No No

—Loan # 2—Yes or No No

—Loan # 3—Yes or No No

—Loan # 4—Yes or No No

—Loan # 5—Yes or No No

Dr. Austin —Loan # 1—Yes or No No

—Loan # 2—Yes or No No

—Loan # 3—Yes or No No

—Loan # 4—Yes or No No

—Loan # 5—Yes or No No

Dr. Neumann —Loan # 1—Yes or No No

—Loan # 2—Yes or No No

—Loan # 3—Yes or No No

—Loan # 4—Yes or No No

—Loan # 5—Yes or No No

Dr. Randall —Loan # 1—Yes or No No

—Loan # 2—Yes or No No

—Loan # 3—Yes or No No

15. *If* and *only if* you did *not* answer "Yes" to all portions of Question No. 14, answer the following question:

Did defendants make any additional untrue statement of material fact or omit to state a material fact at or before the time plaintiffs made loans to Alotel Associates?

Answer: Yes or No Yes

16. *If* and *only if* your answer to Question No. 15 is "Yes", answer the following question:

Did defendants know or in the exercise of reasonable care should they have known that the untrue statement was false in that a material fact had been omitted?

Answer: Yes or No Yes

17. *If* and *only if* your answers to both Questions Nos. 15 and 16 are "Yes", answer the following question *only* with respect to such loan as to which your answer to Question No. 14 was "No":

Which, if any, of plaintiffs did not know of the omitted fact or that the untrue statement was false at the time of making which, if any, loan?

Answer: Dr. Anderson —Loan # 1—Yes or No No

—Loan # 2—Yes or No No

—Loan # 3—Yes or No No

	- Loan # 4—Yes or No No
	—Loan # 5—Yes or No No
Dr. Austin	—Loan # 1—Yes or No No
	—Loan # 1—Yes or No No
	—Loan # 2—Yes or No No
	—Loan # 3—Yes or No No
	—Loan # 4—Yes or No No
	—Loan # 5—Yes or No No
Dr. Neumann	—Loan # 1—Yes or No No
	—Loan # 2—Yes or No No
	—Loan # 3—Yes or No No
	—Loan # 4—Yes or No No
	—Loan # 5—Yes or No No
Dr. Randall	—Loan # 1—Yes or No No
	—Loan # 2—Yes or No No
	—Loan # 3—Yes or No No

Common Law Fraud Claims

In connection with the sale of limited partnership units to plaintiffs:

18. Did the Offering Memorandum contain any untrue statement or omit to state a fact?

Answer: Yes or No Yes

19. *If* and *only if* your answer to Question No. 18 is "Yes", answer the following question:

Was the untrue statement or omission one concerning a material fact?

Answer: Yes or No Yes

20. *If* and *only if* your answers to to both Questions Nos. 18 and 19 are "Yes", answer the following question:

Which, if any, of defendants knew or should have known that the untrue statement was false or that there was an omission?

Answer:	Loftsgaarden	—Yes or No Yes
	Alotel Incorporated	—Yes or No Yes
	Noah	—Yes or No No
	Coult	—Yes or No No
	PDRC	—Yes or No Yes
	2361	—Yes or No Yes

21. *If* and *only if* your answers to both Questions Nos. 18 and 19 are "Yes" *and* your answer to to Question No. 20 included at least one "Yes", answer the following question:

Which, if any, of plaintiffs relied on the untrue statement or omission?

Answer:	Dr. Anderson	—Yes or No Yes
	Dr. Austin	—Yes or No Yes
	Dr. Neumann	—Yes or No Yes
	Dr. Randall	—Yes or No Yes

22. *If* and *only if* your answer to Question No. 21 included one or more answers of "Yes", answer the following question *only* with respect to each plaintiff as to whom your answer to Question No. 21 was "Yes":

Which, if any, of plaintiffs was damaged as a direct result of such reliance?

Answer: Dr. Anderson —Yes or No Yes

Dr. Austin —Yes or No Yes

Dr. Neumann —Yes or No Yes

Dr. Randall —Yes or No Yes

23. *If* and *only if* your answer to Question No. 22 included one or more answers of "Yes", answer the following question *only* with respect to each plaintiff as to whom your answer to Question No. 22 was "Yes":

What is the amount of damages, if any, which each such plaintiff suffered?

Answer: Dr. Anderson —$35,000

Dr. Austin —$35,000

Dr. Neumann —$52,500

Dr. Randall —$35,000

Dated: June 25, 1980

/s/ Michael J. Elasey

Foreperson

TRIAL EXHIBITS

United States District Court
District of Minnesota
Fourth Division

October 6, 1980

[Title Omitted in Printing]

Plaintiff's No. 2

OFFERING MEMORANDUM

ALOTEL ASSOCIATES
A LIMITED PARTNERSHIP

20 LIMITED PARTNERSHIP UNITS

$35,000 PER UNIT

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OFFERING

This offering relates to Units of Limited Partnership of Alotel Associates, a Minnesota Limited Partnership. The Corporate General Partner, Alotel, Incorporated, a Minnesota Corporation, is offering an aggregate of 20 Limited Partnership Units of $35,000 each. The sale of these Units is to be made to not more than 20 persons who are residents of the State of Minnesota. It is not presently contemplated that commissions will be paid. However, the General Partner reserves the right to employ brokers and dealers in which case negotiated commissions will be paid.

The Partnership Agreement provides that unless 70% of the Units (14 Units) are sold within 180 days of the date of the first Unit sale, the Partnership will terminate and all funds received will be returned to investors; until such date, all funds will be held in escrow in a commercial bank.

THE PARTNERSHIP

The Partnership, Alotel Associates, is to be formed as a Minnesota Limited Partnership for the purpose of constructing and thereafter operating a Ramada Inn Motel in Rochester, Minnesota. The term of the Partnership will be until December 31, 2002, or until the project is sold. The Partnership will have as its general partners Alotel, Incorporated, a Minnesota corporation and B. J. Loftsgaarden (the "General Partners"). The Limited Partnership will have an authorized capital consisting of 20 Limited Partnership Units of $35,000.00 each.

INVESTOR SUITABILITY STANDARDS

Because of the size of the investment required of each purchaser of a Limited Partnership Unit, and because of the relative lack of liquidity of this investment the Partnership has established "suitability standards" for those who wish to invest in it. In addition the Partnership is intended to operate as a "tax shelter" and will lead to significantly greater returns for persons in relatively high income tax brackets; correspondingly returns will not be as great for those not in high income tax brackets (assuming the Partnership's income and expenses parallel the estimates of management, of which there is no assurance). Each person who desires to invest must represent that he has either a net worth in excess of $200,000 (excluding home and automobiles) or that some portion of his income is subject to Federal and State income taxes at a rate of 50% or more. He further must represent that he is a resident of the State of Minnesota and is investing for investment purposes and not for the purposes of distribution.

DESCRIPTION OF THE PROJECT

The Partnership proposes to construct a motel containing 170 guest rooms in five stories as well as a restaurant, lounge and commercial areas. The motel will be so constructed as to meet or exceed standards set by Ramada Inns, Inc., the licensor. The lower level will contain a restaurant and 25 of the rooms; eleven of the first floor rooms are to be "cabana" rooms around the indoor-outdoor swimming pool. The motel building will be constructed of precast 8-inch concrete plank floors and ceiling. Walls are to be painted block and vinyl covered wall-

board. There is to be central heating and cooling for the public and commercial areas on the main level. Guest rooms will have through-the-wall individually operated and controlled heating and cooling devices. All public, commercial and guest areas will have carpeting and resilient floor tile. The building will be faced with exterior brick, and architectural panels. The motel tower will contain two elevators with a speed of 125 feet per minute.

The motel is to be built upon a site which will contain enough rooms to construct bituminous parking sufficient for 328 cars. The site will be landscaped as necessary.

THE FRANCHISE

The Partnership through its General Partners has entered into a license agreement with Ramada Inns, Inc. (a Delaware Corporation) for the operation of the motel in Rochester, Minnesota. The Partnership has no relation to Ramada Inns, Inc. other than as a licensee. The license agreement covers an initial period of 20 years. An initial license payment of $15,000 is required. In addition to the initial payment, the Partnership will be required to pay to Ramada Inns an amount equal to 3% of gross room rentals as a royalty fee. Among other provisions the license agreement also: (1) prohibits transfer of the license without the prior consent of Ramada Inns, Inc.; (2) grants to Ramada Inns, Inc. a first right of refusal in the event the motel or any interest therein is proposed to be sold; (3) provides that virtually all supplies and equipment used in the operation of the motel must be purchased from Ramada Inns, Inc. or must be approved by it as to quality; (4) grants the right to use the name, operat-

ing procedures, reservation system and training facilities of the Ramada Inns chain.

LOCATION OF MOTEL

The motel is to be constructed in the south central area of Rochester, Minnesota, on the west side of U.S. Highway 63 between 16th and 17th Street, S.W. The location is within the City of Rochester and is served by all public utilities.

NEARBY MOTELS AND OTHER COMPETITION

In the immediate vicinity of the City of Rochester there are approximately 25 hotels with a total of 2,185 rooms and 40 motels with a total of approximately 2,000 rooms available for occupancy. Of these hotels and motels, the ones which may be considered the most competitive with that to be constructed by the Partnership would be the Holiday Inn located directly across the street from the site of the Partnership's motel and the Howard Johnson Motor Hotel which is located on the other side of the business district in Rochester. The Holiday Inn has available 200 units for occupancy and the Howard Johnson contains approximately 120 units. In addition to these two motels, the City of Rochester has four hotels located in the central business district which have over 100 rooms each. These hotels are the Carlton with 115 rooms, the Kahler with 800 rooms, the Zumbro with 175 rooms and the Holiday Inn Downtown with 338 rooms. With the exception of the Holiday Inn Downtown, these hotels are old and do not contain the amenities which will be available in the Ramada Inn to be constructed by the Partnership.

The City of Rochester has a very large transient population as a result of the location of the Mayo Clinic in the city. It is therefore likely that a containing demand for overnight or short-term living facilities will exist in and around the City of Rochester. There is, however, no assurance that such a demand will continue or that such a demand will lead to high levels of occupancy at the Ramada Inn to be constructed by the Partnership. In addition there is no assurance that other motels or hotels of quality similar to that to be constructed by the Partnership will not be constructed in the near future by others in and around the City of Rochester. In the event such hotels or motels are constructed the operating results of the Partnership may be adversely affected.

CONSTRUCTION OF THE PROJECT BY AFFILIATE

It is presently contemplated that the Partnership will enter into a construction contract with a construction company for the construction and furnishing of the motel for a total expenditure of $3,150,000 (including certain expenditures which will be treated as partnership expenses for tax purposes). See Proposed Budgets included with this Memorandum. The construction company will be owned or controlled by persons who are also in ownership or control of the corporate general partner of the Partnership. It is therefore possible that larger than usual profits could be made by said persons in connection with the construction of the project.

FINANCING

The General Partners have procured a firm commitment for long term financing of the project from Larwin

Realty and Mortgage Trust. The commitment calls for interest to be paid at the rate of 9½% per annum and for the principal to be amortized based on a 28 year schedule with level monthly payments for 12 years and the entire balance due at the end of the 12th year. The total monthly interest and principal payments on the mortgage will be the amount of $19,678.50, the first payment of which will be due in September, 1974. It is presently contemplated that interim construction financing will be obtained from the First National Bank of St. Paul, and that these funds will be acquired at an interest rate of 9½% per year. The land on which the motel project will be built is leased for an initial term of 40 years with renewal options extending thereafter. Total land rent if $37,200 per year. The Partnership has the option to purchase the land under certain conditions.

MANAGEMENT

THE GENERAL PARTNER.

The General Partners, are B. J. Loftsgaarden and Alotel, Incorporated, It is presently contemplated that a management contract will be entered with Alotel, Incorporated and B. J. Loftsgaarden for the initial stages of organization and later for the operation of the motel. In their capacity as general partner and as the manager of the business of the Partnership, the General Partners will have full responsibility and authority for managing the day to day activities of the Partnership. Alotel, Incorporated is a new corporation, formed for the purpose of acting as one of the general partners in this Partnership. However, the principals of Alotel, Incorporated have experience in the hotel management area as set forth below.

The directors and officers of Alotel, Incorporated, their business addresses and their principal occupations are as follows:

NAME AND ADDRESS	POSITION HELD
B. J. Loftsgaarden 740 River Drive St. Paul, Minnesota	President and Director
M. S. Noah 1965 Baird Avenue St. Paul, Minnesota	Secretary and Director
John H. Burg 682 Ivy Falls Court St. Paul, Minnesota	Director
Lyman H. Coult 17508 Manor Road Minneapolis, Minnesota	Vice President and Director
Robert R. Dunlap 832 SW 10th Street Rochester, Minnesota	Director

Mr. B. J. Loftsgaarden has since 1962 been engaged in real estate development. He has acted as general partner of and supervised the initiation, financing, construction and operation of several apartment projects, nursing homes, housing developments and mobile home parks. He developed and is presently one of the managing partners of a large motel in Roseville, Minnesota in addition to his other real esate activities.

Mrs. M. H. Noah is presently engaged in various investment activities.

Mr. Lyman H. Coult is President of Coult Management Co. and Coult Mortgage Co. These companies are

engaged in commercial real estate development and management.

Mr. John H. Burg is President of Hulme Awning and Shade Co., St. Paul, Minnesota; Mr. Robert Dunlap is a practicing attorney.

COMPENSATION OF GENERAL PARTNER.

The Partnership Agreement provides that the General Partners will receive a base management fee for managing the Partnership's properties of $11,500 per year (subject to adjustment if the Partnership's gross revenue increase) plus an additional management fee of ten percent of the net profit of the Partnership before the payment of any installment of principal or interest on any mortgage note on the property (called debt service) and before depreciation or provision for income tax. The additional management fee is limited and may not exceed fifty percent of the cash remaining after the payment of debt service in any fiscal year.

ASSET REQUIREMENTS.

As set forth in another section of this Offering Memorandum, the Internal Revenue Service prior to issuing advance rulings as to the Partnership status of Limited Partnerships in which the sole General Partner is a corporation requires that in cases where total contributions to the Partnership are under $2,500,000 that the net worth of the General Partner be at least equal to fifteen percent of the total contributions. In the case of Alotel Associates, the total contributions are to be $700,000. Accordingly the General Partner would be required to maintain net worth in excess

of $105,000 to satisfy this requirement, if B. J. Loftsgaarden were to cease acting as a general partner. An insurance policy has been taken out on Mr. Loftsgaarden's life, in the amount of $105,000 payable to Alotel, Incorporated. In addition the principals of Alotel, Incorporated have agreed to take such steps as they deem necessary to assure the continued classification of the Partnership as a partnership rather than as an association taxable as a corporation. These steps may include contributions of additional funds to Alotel, Incorporated and/or the substitution or addition of other individual (rather than corporate) General Partners to the Partnership.

OPERATIONAL PERSONNEL.

The General Partners will employ experienced hotel operators and personnel who will be given initial special training both at the Ramada Inn school in Phoenix, Arizona and at the project through the use of training sessions, manuals, and other aids. The operation is thus assured of being up to the standards set by Ramada Inns, Inc., the licensor. Management personnel are required to attend periodic training sessions at Ramada Inn seminars and schools. Ramada Inns, Inc., the licensor, conducts periodic inspection of operations to assure compliance with nationally set standards.

USE OF PROCEEDS

In the event all of the Units offered hereby are sold the proceeds to the Partnership will be $700,000. Of this amount $600,000 will be utilized to construct the motel building and to provide for its furniture and fixtures.

$100,000 will be used to cover initial operating expenses and expendables.

In the event that less than all the Units (but more than 70% thereof) are sold, the Partnership may borrow additional funds or lease certain items of personal property needed in the operation of the motel, in order to complete the Project; this could have a substantial effect on cash distributions to partners and on the potential risk of the investment. Alternatively, the Developer may elect to accept partial payment on the construction cost of the project in Units.

THE LIMITED PARTNERSHIP UNIT

As set forth in the Articles of Limited Partnership, a copy of which is included with this Offering Memorandum, the Limited Partnership Unit has certain rights, liabilities, and obligations. The summary set forth herein is not exhaustive of the matters set forth in the Partnership Agreement and this summary is qualified in its entirety by the Partnership Agreement itself.

PAYMENT FOR LIMITED PARTNERSHIP UNITS. The Limited Partnership Units are to be paid for in cash and are otherwise non-assessable.

LIMITED TRANSFERABILITY. The Limited Partnership Units may not be transferred without the written consent of the General Partners. Limited Partners may, however, assign their beneficial interest in the income attributable to a Unit. The assignee of the beneficial interest in a Unit may be substituted as a Limited Partner only upon meeting certain terms and conditions prescribed in the

Partnership Agreement. There is thus no assurance that any owner of a Limited Partnership Unit will be able to sell or otherwise dispose of his Unit. (Article 17).

AMENDMENTS TO PARTNERSHIP AGREEMENT. The Partnership Agreement may be amended or the General Partners may be replaced upon the vote of two-thirds of the then outstanding Limited Partnership Units. Meetings to consider such amendments are to be called by the General Partners upon the request of the holders of ten percent of the Limited Partnership Units. (Sections 19.1, 19.3, and 19.4).

CONTROL OF PARTNERSHIP ACTIVITY. All activities of the Partnership are to be under the control of the General Partners; Limited Partners may not participate in the operation or control of the Partnership business. (Section 12.2).

POWER OF ATTORNEY. Each holder of a Limited Partnership Unit by executing the Instrument of Execution, grants to the General Partners or either of them his power of attorney to execute certificates and documents on his behalf which relate to the Partnership. Such certificates and documents will include amendments to the Certificate of Limited Partnership or the Partnership Agreement necessitated by the vote of Partners. (Article 23).

ALLOCATION OF PROFITS AND LOSSES. Partnership profits and losses are to be allocated 100% to the Limited Partners (Section 9.2). The amounts allocable to the Limited Partners are to be allocated among them in proportion to the number of Units held by each of them. The General Partners are entitled to compensation for

their services in managing the motel. The basic management fee is 10% of net profit before interest expense, management fees, depreciation and amortization, land rental and income taxes and the additional management fee is equal to 10% of the net cash flow of the partnership. The basic management fee may not exceed fifty percent of the net profit before depreciation and management fee. (Section 10.1).

If the Partnership has taxable income, cash distributions to limited partners will be taxable to them. To the extent that annual depreciation and other expenses exceed the cash income of the partnership, distributions will reduce the tax basis of a Limited Partnership Unit. If at some time the tax basis of a Limited Partnership Unit has been fully recovered, any further distributions in excess of taxable income as reported by the Partnership will generally be taxed at capital gains rates.

Generally, the basis of a Limited Partnership Unit for the purpose of determining gain or loss upon sale or disposition of such Unit will be equal to its cost reduced by Partnership capital distributions in excess of the Partnership's income, further reduced by Partnership losses allocated to the partners and increased by any undistributed Partnership income. Gain or loss realized on the sale or exchange of a Limited Partnership Unit by the holder thereof, who is not a "dealer" will generally be treated as a capital gain or loss except to the extent of any applicable recapture of depreciation which will be treated as ordinary income.

Subject to the recapture of depreciation (taxable as ordinary income) gain which may be earned by the Part-

nership upon the sale or exchange of the Partnership's property will generally be treated as capital gain under applicable Federal income tax provisions so long as the Partnership does not become a "dealer" in real estate. If the Partnership is deemed to be a "dealer" and its investment in the motel is deemed not to be a capital investment, gain or loss upon sale or other disposition of the property would be treated as ordinary gain or loss.

The Internal Revenue Code as amended in 1969 imposes an additional 10% in tax on "items of tax preference" in excess of specified amounts. Depreciation on real estate taken in excess of that allowable on straight line rates and one-half of net long term capital gains are generally tax preference items. The 10% tax on tax preference items is ordinarily payable only if the total of all such items in any taxable year exceeds $30,000, plus the taxpayer's personal income tax for the year. The Partnership presently intends to use accelerated methods of depreciation. However, the general partner may use other methods in the future if it is then felt that this would be in the best interests of the Partnership.

The tax preference provisions further provide that the excess of investment interest expenses over net investment interest will be allowable as a deduction only to the extent of $25,000 plus one-half of such excess over $25,000. The remaining one-half of excess investment interest will be disallowed as a deduction. Investment interest expense as defined as interest incurred to purchase or carry investment property. Each partner of a partnership is required to include his proportionate share of the partnership's excess investment income in computing his own investment interest deduction. Under proposed Treasury regulations

it does not appear that interest expense incurred by the Partnership will be treated as investment interest in view of the fact that the Partnership will derive its revenues from operation of the motel and that no net leases are in force or contemplated. It is possible however that such interpretation may change and that the Partnership would be considered as holding "investment" property rather than as carrying on a trade or business. In that event the adverse tax effects stemming from non-deductibility of portions of investment interest would be applied to each partner.

The Internal Revenue Service has ruled that before issuing an advance ruling to the effect that a limited partnership wherein the sole general partner is a corporation, will be treated as a partnership rather than as an association taxable as a corporation, that certain initial requirements must be met. Among these requirements are:

(1) The limited partners of the partnership do not own in excess of twenty percent of the stock of the general partner;

(2) The net worth of the general partner must equal fifteen percent of the total contribution to the limited partnership (assuming that such tatol contributions are under Two Million Five Hundred Thousand Dollars);

(3) In computing the net worth of a corporate general partner, net worth requirements are to be applied separately for each limited partnership in which the corporate general partner may have an interest, and the corporate general partner must maintain at all times (exclusive of interest in and loans to the partnership in question), net worth at least equal to the sum of the amounts required for each separate partnership.

(4) The Internal Revenue Service has indicated that an individual general partner of a limited partnership must have substantial assets, apart from his interest in the partnership, in order that the partnership will be treated as a partnership and not as an association taxable as a corporation. At present it is intended that the Partnership will have both an individual and a corporate general partner.

Although the general partners, have undertaken to assure to the greatest extent possible that the requirements set forth above will at all times be met and that if at some time they may not be met that alternative methods of assuring the status of the Partnership as a partnership will be taken, there is no assurance that the Partnership will not be considered an association taxable as a corporation at any time. In the event that the Partnership is treated as such an association taxable as a corporation, all Partnership income and expense would not be credited or charged to the limited partners, and the Partnership itself would be subject to tax. Distributions by the Partnership would then be taxable to partners as dividends.

If the administration's tax proposals regarding "limitation on artificial accounting losses" (as presented to the House Ways and Means Committee on April 30, 1973) become law, it could result in the disallowance of deductions in excess of income generated by the project each year. However, such excess deductions could be carried forward to offset future income of the project. The effect on an investor in this project would be to eliminate the forecasted income tax savings for the years 1973 through 1976 with a corresponding elimination of the forecasted income tax cost for the years 1977 through 1982.

The foregoing description is not intended as a substitute for careful tax planning. Each purchaser of a Limited Partnership Unit is urged to consult his tax advisors with specific reference to his own situation and potential changes in the applicable tax laws.

NON-REGISTRATION

The Partnership does not intend to file registration statements with the State of Minnesota or with the Securities and Exchange Commission, Washington, D. C. The Partnership has however filed a Statement of Issuer with the State of Minnesota Securities Division, and an order permitting sale of these Units to Minnesota residents has been issued. The Partnership will rely upon exemptions from registration under the Securities Act of 1933 and the Securities Laws of the State of Minnesota. In connection with this reliance it is necessary that each prospective investor represent that he is purchasing a Limited Partnership Unit for investment purposes and not for purposes for resale or other distribution and that he is a resident of the State of Minnesota. Each subscriber will be required to execute in connection with his Instrument of Execution an "Investment and Non-Distribution Letter" setting forth his representations and warranties as to his intention when purchasing the Unit and agreeing to the imposition of restrictions on the Units to be issued to him.

APPRAISAL AND OPINIONS OF FEASIBILITY

Included with this memorandum are the Appraisal Certificate Page and feasibility portions of an appraisal of the project prepared by O. J. Janski, a member of the

American Institute of Real Estate Appraisers (MAI). These documents are part of a complete appraisal report, copies of which are available from the General Partners. The appraisal is based on information available to the appraiser. The General Partners make no representation that the property or project could be sold for the price set foth as its appaised value in the Appraisal Report.

PRCPOSED BUDGETS

Included with this memorandum are budgets showing budgeted receipts, and disbursements of the Partnership over future periods. These budgets are based upon present information and no representation can be made that they will necessarily reflect the future operations of the motel.

October 24, 1972

B. J. Loftsgaarden Enterprises
2540 North Cleveland Avenue
St. Paul, Minnesota 55113

Gentlemen:

In accordance with your request, I have made an inspection and an appraisal of the property to be constructed and known as the Ramada Inn, Rochester, Minnesota. This property is located on the west side of U. S. Highway 63 between 16th Street Southwest and 17th Street Southwest in the south-central area of the City of Rochester.

The value estimate, as it is hereinafter reported, is predicated upon completion of the construction as indicated in the plans, specifications, and other exhibits, in full accordance with all applicable codes and ordinances, as well as the

requirements of Ramada Inns, Inc. Based upon my inspection of the property, information supplied by your office and others, and a study of the market conditions as it relates to this property, it is my judgment that subject to the conditions and limitations as hereinafter stated, as of October 15, 1972, this property had a market value as indicated below:

Land	$ 385,000
Improvements	$2,690,000
F. F. & E.	$ 425,000
Total	$3,500,000

The accompanying report contains data secured from my personal investigation and from other sources considered to be reliable. Insofar as possible, it has all been checked and verified. The correctness, however, is not guaranteed.

Yours truly,
/s/ O. J. Janski, MAI

FEASIBILITY

It is probably a trite expression to state that Rochester is unique, but it is true, if for no other reason that it is the location of world-renowned medical facilities. Rochester is notable also for having a strong economic base and a growing population. Both are sustained in part by thousands of patients and visitors annually. The need for hotel-motel accommodations is inordinately large, and accommodations exceed at least nu-

merically those offered in most cities of equal size. A copy of part of the Rochester Hotel-Motel Guide is in the Exhibits section of this report.

My investigation of the site and the community as a part of my appraisal of the proposed Ramada Inn has convinced me that a franchise motel operation as indicated is a feasible undertaking and has good opportunity for success. The proposed site is across the street from the Holiday Inn that has undergone several recent expansions. The Holiday Inn site at 1630 South Broadway is inferior, because it is below street grade elevation, but the consequent design problems have not retarded its patronage and growth according to the evaluation specialist in the county government I consulted. At the present time, it has 200 rooms with rates $12 and $18 daily.

Another indication of what to expect is the recent experience of the 120-room Howard Johnson Motor Lodge located across town from the subject at 435 - 16th Avenue Northwest. This is the most recently constructed motel which opened in the Spring of 1972. The motel manager advised me that the most recent experience was an occupancy level of above 80% and that in his opinion, higher levels of occupancy were a good prospect. The manager was enthusiastic and apparently not inclined to discourage competition. Rates are $14 to $20 daily. A public announcement has been made of a Hilton motel franchise to be constructed near the Apache Shopping Center. To my knowledge, no on-site activity has taken place. Aside from the downtown hotels, the two motels referred to are the only ones with over 100 rooms and with similar food and beverage facilities to that to be offered by the proposed Ramada Inn. Altogether, my prognosis is favorable for the subject.

April 23, 1973

Alotel, Incorporated
2361 Highway 36
St. Paul, Minnesota 55113

Re: Alotel Associates, a Limited Partnership

Gentlemen:

You have requested our opinion as to certain Federal Income Tax matters related to Alotel Associates, a Limited Partnership, to be formed under the laws of the State of Minnesota.

Our opinion as expressed in this letter is based upon the Internal Revenue Code and the regulations and interpretation presently in effect. The Internal Revenue Code, the regulations and interpretations thereunder are all subject to change. The opinion as hereinafter stated is further based upon the following assumptions:

(a) The partnership will be formed under the laws of the State of Minnesota and the general partners will be and remain Alotel, Incorporated, a Minnesota Corporation and B. J. Loftsgaarden, an individual of substantial means.

(b) Alotel, Incorporated will at all times maintain net worth, exclusive of its interest in Alotel Associates or any other limited partnership, in excess of 15% of total contributions to all such partnerships in the event B. J. Loftsgaarden ceases to act as an additional general partner.

(c) The limited partners of Alotel Associates will at no time own in excess of twenty (20) percent of the capital stock of Alotel, Incorporated;

(d) Alotel Associates, will invest in and continue to carry on the business of one motel;

(e) The other facts and operations described and proposed in the Organizational Documents and the Offering Memorandum prepared in connection with the offering of the Limited Partnership Units will at all times be true.

Based upon the foregoing items, and subject to the foregoing provisos, we are of the opinion that Alotel Associates will be regarded as a Partnership for Federal Income Tax purposes and will not be treated as an association taxable as a corporation.

Yours very truly,
DOUGLASS, BELL, DONLIN,
SHULTZ & PETERSEN

April 25, 1973

Mr. B. J. Loftsgaarden
2540 North Cleveland Drive
Saint Paul, Minnesota 55113

Gentlemen:

The accompanying forecasts of Alotel Associates (a limited partnership) for the years 1973 through 1992, shown on pages 2 through 6, were prepared to provide estimates of net cash flow returned to partners and tax consequences of projected operations to limited partners. The forecast statements have been prepared using the assumptions and rationale set forth on pages 7 to 13.

We have reviewed the assumptions and rationale underlying the forecast financial statements. We are un-

able to evaluate the reasonableness of the forecasted occupancy rates or the forecasted 4% annual increase in net operating revenue (Note 3). We are also unable to evaluate the reasonableness of the forecasted refinancing of the project in 1986 (Note 10). Further, we believe that the lives assigned to the building and to the components (Note 7) may be aggressive. All other assumptions and rationale appear reasonable and appropriate for the purpose of this forecast.

Since forecasts are based on assumptions about circumstances and events that have not yet taken place, they are subject to the variations that may arise as future operations actually occur. Accordingly, we cannot give assurance that the predicted results will actually be attained.

Touche Ross & Co.
Certified Public Accountants

ALOTEL ASSOCIATES FORECAST OF CASH FLOW AND TAXABLE INCOME OR LOSS

	Eight months ending December 31, 1973	1974
CASH SOURCES:		
Net operating revenue (Note 3)		$296,170
Working capital (Note 16)		33,240
TOTAL		329,410

CASH REQUIREMENTS:		
Real estate taxes (Note 4)		8,800
Mortgage principal (Note 10)		5,630
Mortgage interest (Note 10)		219,384
Loan principal (Note 10)		40,666
Loan interest (Note 10)		17,730
Management fee (Note 5)		
Replacement reserve payments (Note 10)		37,200
Land rental (Note 6)		
TOTAL		329,410
NET CASH FLOW (Note 11)		$ —
TAXABLE INCOME OR LOSS:		
Net cash flow		
Add:		
Mortgage principal payments		5,630
Loan principal payments		40,666
Replacement reserve payments		
(Deduct):		
Depreciation (Note 7)	($103,192)	(275,206)
Amortization of loan and franchise fees		(542)
Real estate taxes accrued in excess of amount paid	(2,100)	(31,200)
Construction period losses (Note 8)	(302,600)	
Working capital applied		(33,240)
TAXABLE INCOME OR (LOSS) (Notes 11 and 17)	($407,892)	($293,892)

This projection is dependent on future events and may be significantly affected by changes in economic and other circumstances.

The accompanying assumptions and rationale are an integral part of this forecast.

ALOTEL ASSOCIATES FORECAST OF CASH FLOW
AND TAXABLE INCOME OR LOSS

	1982	1983	1984
CASH SOURCE:			
Net operating revenue	$706,116	$727,513	$748,910
CASH REQUIREMENTS:			
Real estate taxes	52,800	54,400	56,000
Mortgage principal	34,903	38,367	42,175
Mortgage interest	201,239	197,775	193,967
Loan principal	44,041,	47,696	51,655
Loan interest	14,355	10,700	6,741
Management fee	90,957	94,717	98,479
Replacement reserve payments			
Land rental	37,200	37,200	37,200
TOTAL	475,495	480,855	486,217
NET CASH FLOW	$230,621	$246,658	$262,693
TAXABLE INCOME OR LOSS:			
Net cash flow	$230,621	$246,658	$262,693
Add:			
Mortgage principal payments	34,903	38,367	42,175

Loan principal payments	44,041	47,696	51,655
Replacement reserve payments			
(Deduct):			
Amortization of loan and franchise costs	(875)	(875)	(875)
Depreciation	(136,051)	(124,715)	(113,430)
TAXABLE INCOME OR (LOSS)	$172,639	$207,131	$242,218

This projection is dependent on future events and may be significantly affected by changes in economic and other circumstances.

The accompanying assumptions and rationale are an integral part of this forecast.

ALOTEL ASSOCIATES
SUMMARY OF INVESTMENT
PER $35,000 UNIT

(for 54% tax bracket investor — combined federal and Minnesota rate)

Year	Investment	Partnership taxable income or (loss) (Note 17)	Income tax savings or (cost) (Note 17)	Investment credit (Note 15)
1973	$35,000	($20,395)	$11,013	$2,432
1974		(14,695)	7,935	
1975		(2,960)	1,598	
1976		(476)	257	
1977		1,929	(1,042)	
1978		4,997	(2,698)	
1979		7,222	(3,900)	
1980		5,514	(2,978)	1,225

1981		6,935	(3,745)	
1982		8,632	(4,661)	
1983		10,357	(5,593)	
1984		12,111	(6,540)	
1985		13,898	(7,505)	
1986		15,604	(8,426)	
1987		6,826	(3,686)	1,225
1988		7,719	(4,168)	
1989		9,587	(5,177)	
1990		11,226	(6,062)	
1991		12,896	(6,964)	
1992*				
	$35,000	$96,927	($52,342)	$4,882

*Note 13

This projection is dependent on future events and may be significantly affected by changes in economic and other circumstances.

The accompanying assumptions and rationale are an integral part of this forecast.

ALOTEL ASSOCIATES
PROJECTED SOURCE AND APPLICATION OF FUNDS THROUGH THE END OF CONSTRUCTION PERIOD (DECEMBER 31, 1973)

SOURCE

Mortgage proceeds	$2,310,000
Loan proceeds	240,000
Capital contributions by investing limited partners	700,000
Sale of land	300,000
	$3,550,000

APPLICATION

Land		$ 300,000
Building and costs allocated to building:		
Building	$2,000,000	
Paving and landscaping	60,000	
Architect's fee	90,000	
Legal and accounting	5,000	
Tests and permits	7,500	
Overhead and profit	103,900	2,266,400
Furniture and fixtures		600,000
Intial franchise fee to be amortized over the life of the building		15,000
Costs to be amortized over the term of the mortgage:		
Title insurance	2,500	
Related legal fees	3,500	6,000
Costs to be deducted through construction period:		
Land rent	2,800	
Sales tax on furniture, fixtures and building materials	44,000	
Construction loan interest	130,000	
Interim financing fee	23,100	
Legal and accounting	10,000	
Commitment fee	46,200	
Mortgage registration tax	3,500	
Appraisal fee	3,000	
Pre-opening expenses	40,000	302,600
Working capital		60,000
		$3,550,000

This projection is dependent on future events and may be significantly affected by changes in economic and other circumstances.

The accompanying assumptions and rationale are an integral part of this forecast.

ALOTEL ASSOCIATES

FORECAST OF NET OPERATING REVENUE AT VARIOUS OCCUPANCY LEVELS (NOTE 3)

Operating revenues:

- Rooms
- Telephone
- Newsstand
- Guest laundry and valet
- Miscellaneous machines
- Other income
- Food and beverage

Operating expenses:

- Room expenses
- Telephone
- Newsstand
- Guest laundry and valet
- Miscellaneous machines
- Food and beverage
- Administrative
- Advertising
- Utilities
- Repairs and maintenance
- Insurance
- Food and beverage payroll
- Other restaurant expenses
- License royalties

Net operating revenue

This projection is dependent on future events and may be significantly affected by changes in economic and other circumstances.

The accompanying assumptions and rationale are an integral part of this forecast.

ASSUMPTIONS AND RATIONALE

1. Classification of partnership

The forecast assumes that the organization will be treated for income tax purposes as a partnership. If instead the organization were classified "an association" and taxed as a corporation, many of the advantageous tax attributes would be lost.

The general partners are Alotel, Incorporated and B. J. Loftsgaarden, an officer and majority shareholder of the corporate general partner. Although no advance ruling will be requested from the Internal Revenue Service, it is believed that the organization will be classified as a partnership for income tax purposes.

2. Method of accounting

The Limited Partnership will use the accrual basis method of accounting in keeping its books and in reporting for income tax purposes.

3. Operations

The partnership will own and operate a Ramada Inn in Rochester, Minnesota. The Inn will contain 170 guest rooms in addition to a restaurant and commercial areas. It is assumed that the partnership will enter into a contract with an affiliate of the general partner to acquire the land and furniture and fixtures and construct the building for a total fee of $3,450,000 less all interest, fees, and expenses (other than pre-opening expenses) incurred by the partnership during the construction period.

The forecast of net operating revenue at various occupancy levels was based on the experience of comparable Ramada Inn projects and was furnished to the general partners by Ramada Inns, Inc.

The projected net operating revenue for 1974 is based on a 50% occupancy rate. An occupancy rate of 75% beginning January 1, 1975 is assumed in the projections.

It has been assumed that net operating revenue will increase approximately $22,500 per year (4% per year based on 1975 net operating revenue).

4. Real estate taxes

Real estate taxes in the forecast for 1973 and 1974 are based upon anticipated valuation of the property at tax valuation dates and available information on current taxes. It has been assumed that real estate taxes increase approximately $1,600 per year (4% per year based on 1975 real estate taxes).

5. Management fee

A management fee payable to the general partner has been provided in the forecast. The fee is the sum of the following:

(1) 10% of the difference between net operating revenue and real estate taxes, limited however to 50% of net profit (before depreciation and the payment of any management fee), plus

(2) 10% of net cash flow (after payment of the management fee in (1) above.)

6. *Land rental*

The general partner has leased a portion of the land to be used for the project at an annual rental rate of $4,200 per year. The lease has seven years remaining of the original term and is subject to three additional terms of five years each at the same annual rental rate. The general partner has reached an agreement with the lessor for an additional term of 13 years. The lease provides that the lessee has the first option to purchase the property if the lessor desires to sell the property.

It has been assumed that the remaining land necessary for the project will be purchased in May of 1973 for $300,000 and will be sold for the same amount on December 31, 1973. It has also been assumed that the land would be leased back to the partnership for $33,000 a year under terms similar to those under the existing lease.

7. *Depreciation*

Acquisition and construction costs have been allocated to components and useful lives assigned and depreciation methods selected as follows:

	Cost	Life	Depreciation method
Building	$1,290,411	40 years	150% declining balance
Mechanical, electrical, roof, pool and landscaping	800,460	20 years	150% declining balance
Elevators	94,739	15 years	150% declining balance
Furniture and fixtures	600,000	7 years	Sum-of-the-years digits
Painting	80,790	4 years	150% declining balance
	$2,866,400		

Separation of building costs into components for purposes of depreciation is permitted for tax purposes. However, there are no established guidelines for the useful lives of the components and, therefore, the lives used in the forecast are subject to challenge by the Internal Revenue Service.

Eligibility for use of accelerated depreciation methods requires original use of the property by the Limited Partnership. Depreciation is assumed to begin December 1, 1973.

The Internal Revenue Code allows first-year depreciation (in addition to other depreciation) equal to 20% of the investment in tangible personal property for the year. The additional first-year depreciation is limited to $4,000 per taxpayer ($2,000 if married and filing separately). The depreciation expense includes additional first-year depreciation of $80,000 in 1973, $70,000 in 1980 and $70,000 in 1987.

8. Construction period losses

Construction period losses of $302,600 are forecasted for 1973.

It is anticipated that construction on the project will begin in May of 1973 and will be completed by December of 1973. The hotel may be opened for occupancy in December of 1973 but it is anticipated that the net income from oper-

ations for 1973 would be an insignificant amount. Therefore no revenues or expenses from hotel operations for 1973 have been shown in the forecast.

9. Basis of limited partners

The mortgage loan will be made to the Limited Partnership on a nonrecourse basis, i.e., the lender agrees to look only to the mortgaged property for repayment of the loan. Under existing regulations, a limited partner may add his proportionate share of such a mortgage loan to his cash investment in determining the basis in his partnership interest. This will enable him to receive cash distributions generated by the Limited Partnership in excess of his cash investment without recognizing currently an equivalent amount of taxable income.

10. Financing

It has been assumed that, based on discussions the general partner has had with financial institutions, the limited partnership will obtain $2,310,000 of construction financing at an interest rate of 9½%. It has also been assumed that a permanent mortgage of $2,310,000 at 9½% interest with an amortization schedule based on 28 years, but a term of 12 years, will be closed on September 1, 1974.

For purposes of the projection it has been assumed that upon retirement of the mortgage at its maturity (1986), a new mortgage of 148% (i.e. 4% per year increase from 1975 through 1986) of the original mortgage or $3,418,800 with similar terms will be placed on the property.

The proceeds from the refinancing (after repayment of the original mortgage) will be distributed to the partners.

It has also been assumed that a $240,000, five year, 8% loan, repayable in equal monthly installments will be obtained in January of 1974 and similar loans will be obtained in 1981 and 1988. The proceeds of the loan in 1981 together with assumed replacement reserve payments in 1979 and 1980 of $55,000 each year will be used to replace worn out furniture and fixtures. The same assumption is made regarding the proceeds of the loan received in 1988 and the replacement reserve payments for 1986 and 1987.

11. Division of income or losses and cash flow

The limited partners will have a 100% aggregate interest in the income or losses and net cash flow from operations.

The proceeds from a sale or refinancing of the project will be distributed to the limited partners to the extent of their original capital contribution ($700,000). The excess, if any, of the proceeds over $700,000 will be distributed 75% to the limited partners and 25% to the general partners.

12. Application of minimum tax on tax preference items

The Internal Revenue Code imposes a 10% tax (in addition to other taxes) on certain tax preference items. The tax preference items which will affect the partners are:

> The excess of accelerated over straight-line depreciation on real property. For each $35,000 investment unit, this item approximates $200 in 1973, $2,200 in 1974, $1,400 in 1975 and decreases in subsequent years.

The 50% capital gains deduction of individuals (assuming a capital gain is realized at the time of sale of the motel complex).

The 10% tax is imposed only on the excess of a taxpayer's tax preference items over the sum of: $30,000 ($15,000 in the case of a married taxpayer filing a separate return), his federal income tax otherwise computed for the year and carryovers of federal income taxes paid in prior years.

Maximum tax on earned income

Taxpayers otherwise eligible for the 50% maximum tax on earned income may lose part of the benefit therefrom, if total tax preference items (including those generated by this investment) exceed $30,000.

13. Taxation of gain from sale

A portion of the gain on sale of the property may be taxed as ordinary income under the "depreciation recapture" provisions of the Code. In the case of a building, only the excess of accelerated depreciation over straight-line depreciation is subject to recapture.

No attempt has been made to forecast a price at which the project might be sold in 1992 or at any other time, because the future events which would determine such a price are hightly uncertain and unpredictable. If the project were sold in 1992 the amount of gain *in excess of any cash received* would be $115,836 per $35,000 investment unit and the tax payable on that gain would be $32,223 computed as follows:

Cumulative cash distributions		$247,763
Less:		
Investment	$ 35,000	
Cumulative taxable income	96,927	131,927
Gain on sale		$115,836
Depreciation recapture - taxed as ordinary income	$ 3,510 at 54%	$ 1,895
Remainder - taxed as capital gain	112,326 at 27%	30,328
Total Tax		$ 32,223

No effect has been given to a possible minimum tax on tax preference items. The capital gains tax has been computed by using a rate of one-half of the assumed tax bracket of the limited partner.

14. Excess investment interest

Beginning in 1972, the Revenue Code limits the deductibility of excess investment interest. Interest paid in the active conduct of a trade or business is not considered investment interest. Assuming that in each year the motor hotel operating expenses (exclusive of land rent, real estate taxes, interest and depreciation) exceed 15 percent of the gross rental income, the operations of this motor hotel project should be considered the conduct of a trade or business and there should be no limitation on the deductibility of interest paid by the Limited Partnership.

15. Investment tax credit

The "summary of investment" reflects an investment tax credit based on a limited partner's share of the part-

nership investment in "eligible" property (tangible personal property and elevators). The investment tax credit is available to a limited partner as a credit against his federal income tax liability, but may be limited if his total investment credits exceed the lesser of his federal tax liability or $25,000 ($12,500 if married and filling separately).

16. Working capital

It has been forecasted that at the end of the construction period the Partnership will have working capital of $60,000 after payment of all construction and acquisition costs, fees and other expenses. It has been assumed that $33,240 of working capital will be used to cover the projected cash deficit from operations for 1974.

17. Proposed federal income tax legislation

The forecasted income tax consequences to an investor are based on current tax law, case history, and interpretive rulings. If the administration's tax proposals regarding "limitation on artificial accounting losses" (as presented to the House Ways and Means Committee on April 30, 1973) become law, it could result in the disallowance of deductions in excess of income generated by the project each year. However, such excess deductions could be carried forward to offset future income of the project. The tax proposals exempt investments where commitments have been made on or before April 30, 1973. It is unclear if investment in this project would be exempted from the proposed legislation. If such legislation was enacted and affected this project, the effect on an investor in this project

could be to eliminate the forecasted income tax savings for the years 1973 through 1976 with a corresponding elimination of the forecasted income tax cost for the years 1977 through 1982.

ARTICLES OF LIMITED PARTNERSHIP OF ALOTEL ASSOCIATES

THESE ARTICLES OF LIMITED PARTNERSHIP, made and entered into this ..... day of ....., 1973, by and between Alotel, Incorporated, a Minnesota corporation, B. J. Loftsgaarden and the persons executing counterparts hereof as limited partners.

WITNESSETH:

WHEREAS, the parties hereto desire to constitute themselves as a Limited Partnership pursuant to Minnesota Statutes, Chapter 322, entitled "Limited Partnerships"; and

WHEREAS, the parties desire to form this Limited Partnership for the purpose of constructing and thereafter operating for income a motel in Rochester, Minnesota.

WHEREAS, the parties desire to provide for (i) the holding of title to the Property, (ii) division of the profits and losses from the operation or sale thereof, (iii) restrictions on disposition and management of the Property, and (iv) various other matters relating thereto;

NOW, THEREFORE, for and in consideration of the mutual covenants and agreements herein contained and other good and valuable considerations, the parties hereto agree as follows:

ARTICLE 1.
FORMATION OF LIMITED PARTNERSHIP

1.1) The parties hereto hereby form a Limited Partnership pursuant to the provisions of the Uniform Limited Partnership Act of the State of Minnesota, (Chapter 322, Minnesota Statutes) as amended.

ARTICLE 2.
NAME AND PLACE OF BUSINESS

2.1) The name of the Partnership shall be Alotel Associates. The principal place of business shall be located in Rochester, Minnesota, or such other place as the General Partner may designate by giving written notice to the Limited Partners not less than ten (10) days preceding any such change.

ARTICLE 3.
CERTIFICATE OF LIMITED PARTNERSHIP

3.1) The parties hereto understand that a Certificate of Limited Partnership will be prepared pursuant to the provisions of Section 322.02 of the Uniform Limited Partnership Act of Minnesota containing certain of the information set forth herein. The General Partners will cause the Certificate to be recorded in the office of the Register of Deeds of the county in which the principal place of business of the Partnership is situated.

ARTICLE 4.
DEFINITIONS

4.1) For purposes of these Articles the following words and terms shall have the indicated meanings, unless clearly designated otherwise:

(01) NET PROFITS AND NET LOSSES. The terms "Net Profits" and "Net Losses" mean net profits and net losses as determined by generally accepted accounting principles.

(02) CAPITAL ACCOUNT. The capital account of a Partner at any time means the total cash or other property contributed by the Partner to the Partnership plus profits allocated and less losses allocated and cash or other property previously distributed.

(03) GENERAL PARTNER. The "General Partner" means Alotel, Incorporated, and B. J. Loftsgaarden. The "Corporate General Partner" shall mean Alotel, Incorporated and the "Individual General Partner" shall mean B. J. Loftsgaarden. References to the "General Partner" shall include either or both of the general partners.

(04) LIMITED PARTNERS. "Limited Partners" means the signatories hereto purchasing a Unit or Units.

(05) UNIT. "Unit" means a Limited Partnership Unit as authorized by Section 8.2 hereof.

(06) PARTNERSHIP. "Partnership" means the Limited Partnership of Alotel Associates.

(07) PROPERTY. The "Property" means the real property to be acquired or leased by the Partnership and upon which will be built and operated the motel hereinbefore mentioned; the Property shall include such motel.

(08) ARTICLES. The "Articles" means the Articles of Limited Partnership of Alotel Associates.

(09) PARTNER. A "Partner" means and includes the General Partner and all Limited Partners.

(10) CERTIFICATE. The "Certificate" means the Certificate of Limited Partnership of Alotel Associates.

(11) CASH FLOW. "Cash Flow" shall mean net income plus depreciation and amortization, expenses accrued and not paid; less principal payments on notes and mortgages, and replacement reserve payments.

ARTICLE 5.
PURPOSES OF THE PARTNERSHIP

5.1) The principal purpose of this Limited Partnership is to acquire, maintain, operate, and dispose of the Property, and to engage in any and all general business activities relating or incidental thereto. The Partnership shall engage in business only in the State of Minnesota and shall engage in no other business.

ARTICLE 6.
PARTNER'S NAMES AND ADDRESSES

6.1) GENERAL PARTNER. The names and common business addresses of the General Partners are Alotel, Incorporated, (a Minnesota corporation), 2361 Highway 36, St. Paul, Minnesota, 55113; B. J. Loftsgaarden, 2540 North Cleveland Drive, St. Paul, Minnesota 55113.

6.2) LIMITED PARTNERS. The name and address of each Limited Partner in the Partnership shall be set forth on a document evidencing his acceptance and adoption of each and every provision of these Articles.

ARTICLE 7.
TERM OF PARTNERSHIP

7.1) The term of the Partnership shall commence on the date of the recording of the Certificate in the office of the Register of Deeds in the County of Olmsted, State of Minnesota, and shall continue thereafter until the 31st day

of December, 2002, or until the Property is sold, or until terminated as hereinafter provided, whichever date is the earliest.

ARTICLE 8.
PARTNERSHIP CAPITAL CONTRIBUTIONS

8.1) GENERAL PARTNERS. The General Partners shall make no capital contribution to the Partnership.

8.2) LIMITED PARTNERSHP UNITS. There are hereby authorized 20 Limited Partnership Units of $35,000 each. Each subscriber shall become a Limited Partner at such time as he has (a) contributed the sum of $35,000 to the Partnership for each Unit purchased; (b) he and either of the General Partners have executed the Instrument of Execution; and (c) the Certificate has been filed or amended as provided in Minnesota Statutes Chapter 322.

8.3) WITHDRAWAL BY LIMITED PARTNER. No Limited Partner shall withdraw any of his capital without the consent of the General Partner.

8.4) INDIVIDUAL ACCOUNTS. An individual account shall be maintained for each Partner.

8.5) LIABILITY OF LIMITED PARTNER. No Limited Partner shall be personally liable for any of the debts of the Partnership or any of the losses thereof in excess of the amount contributed by him to the capital of the Partnership under ARTICLE 8 hereof. No Limited Partner shall be responsible for any of the debts or losses of any other Partner.

ARTICLE 9.
ALLOCATION OF PROFITS AND LOSSES

9.1) FISCAL YEAR. For purposes of Partnership accounting and for income tax reporting, the Partnership shall adopt a fiscal year ending on the last day of December of each year.

9.2) ALLOCATION OF NET PROFITS AND LOSSES. Profits and losses of the Partnership shall be allocated as follows:

(01) Net profits and net losses other than from the sale or condemnation of all or part of the Property shall be allocated 100% to the Limited Partners.

(02) Net profits upon sale or condemnation of all or part of the Property to the extent of net cash proceeds to the Partnership plus cash distribution made pursuant to Section 10.3 shall be allocated in accordance with the provisions of Section 21.1(04); to the extent that such net profit exceeds the net cash proceeds to the Partnership plus cash distributions made pursuant to Section 10.3, it shall be allocated 100% to the Limited Partners. Net losses upon sale or condemnation of the Property shall be allocated 100% to the Limited Partners.

9.3) ALLOCATION OF PROFIT OR LOSS AMONG LIMITED PARTNERS. Amounts allocable to Limited Partners pursuant to Section 9.2 shall be allocated in the ratio which the number of Units held by each of them bears to the number of Units held by all of them.

ARTICLE 10.
COMPENSATION AND DISTRIBUTIONS

10.1) COMPENSATION TO GENERAL PARTNERS. The General Partners shall receive as compensa-

tion for their services in managing the Property and business of the Partnership:

(01) A base management fee equal to 10% of the Net Profits of the Partnership before interest expense, management fees, depreciation and amortization, land rental, and income taxes. Such base management fee shall not exceed 50% of such Net Profits before depreciation and management fee.

(02) An additional management fee equal to 10% of cash flow of the Partnership.

10.2) DISTRIBUTION OF CASH GENERALLY. Subject to the maintenance of a sound financial position the General Partners shall distribute accumulated cash generated other than from the sale or condemnation of the Property, and other than from the refinancing of all or a substantial portion of the Property, to the holders of Units of record on the last day of each fiscal year as soon as practicable after the end of each fiscal year.

10.3) DISTRIBUTION OF CASH UPON REFINANCING. If the Property shall be refinanced by subjecting it to new, additional, or substitute mortgages or security interests subsequent to the initial acquisition and construction of the Property, and if the Partnership shall receive cash in excess of that used to satisfy existing mortgages and security interests upon such refinancing, then cash distributions made during the year of such refinancing or immediately following the year of such refinancing shall be made in accordance with the provisions of Section 21.1(04) to the full extent of such excess cash. All amounts so distributed shall be deducted from the amounts otherwise distributable pursuant to Section 21.1(04) upon the sale or condemnation of the Property and the termination of the Partnership.

ARTICLE 11
LIMITATION UPON WITHDRAWAL

11.1) RIGHT TO WITHDRAW. No Limited Partner shall have the right to withdraw or reduce his contribution to the capital of the Partnership. However, such withdrawal may be accomplished pursuant to the provisions of ARTICLE 6 hereafter.

11.2 LIMITATIONS UPON PROPERTY AND PRIORITY. No Limited Partner shall have the right to demand or receive property other than cash in return for his contribution, and no Limited Partner shall have priority over any other Limited Partner, either as to contributions of capital or as to compensation by way of income, except as their interests may appear in the capital accounts of the Partnership.

ARTICLE 12.
STATUS OF LIMITED PARTNERS

12.1) LIABILITY. A Limited Partner shall not be bound by, or be personally liable for, the expenses, liabilities or obligations of the Partnership.

12.2) LACK OF CONTROL. A Limited Partner shall take no part in or interfere in any manner with the conduct or control of the business of the Partnership and shall have no right or authority to act for or bind the Partnership.

ARTICLE 13.
MANAGEMENT, DUTIES, POWERS, RESTRICTIONS OF THE GENERAL PARTNER

13.1) GENERAL. The General Partners shall be responsible for the management of the Partnership busi-

ness with all rights and powers generally conferred by law or necessary, advisable or consistent in connection therewith.

13.2) SPECIFIC. In addition to any other rights and powers which they may possess, the General Partners shall have all specific rights and powers required or appropriate to management of the Partnership business which, by way of illustration but not by way of limitation, shall include the following rights and powers.

(01) To acquire, hold and dispose of any real property, interest therein, or appurtenant thereto, as well as personal or mixed property connected therewith, including the purchase, lease, development, improvement, maintenance, exchange, trade or sale of such properties, at such price, rental or amount, for cash, securities or other property, and upon such terms, as it deems, in its absolute discretion, to be in the best interests of the Partnership.

(02) To borrow money and, if security is required therefor to mortgage, or subject to any other security device any portion of the property of the Partnership, to obtain replacements of any mortgage or other security device, and to prepay, in whole or in part, refinance, increase, modify, consolidate, or extend any mortgage or other security device, all of the foregoing at such terms and in such amounts as it deems, in its absolute discretion, to be in the best interests of the Partnership.

(03) To place record title to, or the right to use, Partnership assets in the name or names of a nominee or nominees, or in the name of either General Partner for any purpose convenient or beneficial to the Partnership.

(04) To acquire and enter into any contract of insurance which the General Partners deem necessary and proper for the protection of the Partnership, for the conservation of its assets, or for any purpose convenient or beneficial to the Partnership.

(05) To employ from time to time persons, firms, or corporations for the operation and management of the Partnership and the Property, including, without limitation, operating personnel, rental agents, accountants, insurance brokers, real estate brokers, building management agents, loan brokers, and attorneys on such terms and for such compensation as it shall determine, notwithstanding the fact that its officers and directors or subsidiaries and affiliates thereof, may have a financial interest in such firms or corporations, such compensation to be an expense of the Partnership.

13.3) LIMITATIONS. The General Partners shall have all the rights and powers and be subject to all the restrictions and liabilities of a Partner in a partnership without limited partners. The General Partners have no authority without the written consent or ratification of the specific act by all the Limited Partners to:

(01) Do any act in contravention of the Certificate and these Articles;

(02) Do any act which would make it impossible to carry on the ordinary business of the Partnership;

(03) Confess a judgment against the Partnership;

(04) Possess property or assign the rights of the Partnership in specific property for other than a Partnership purpose;

(05) Admit a person as a General Partner except as otherwise provided in these Articles;

(06) Admit a person as a Limited Partner except as otherwise provided in these Articles.

13.4) COMPETITION. Any of the Partners, or any shareholder, officer, director, employee, or other person holding a legal beneficial interest in an entity which is a General Partner or a Limited Partner herein, may engage in or possess an interest in other business ventures of every nature and description, independently or with others, including, but not limited to, the ownership, financing, leasing, operation, management, syndication, brokerage and development of real property; and neither the Partnership nor any Partner shall have any right by virtue of this Agreement in and to such independent ventures or to the income or profits derived therefrom. Nothing herein contained shall require a General Partner to give notice to the Limited Partners or any of them as to such other business ventures or to present to the Partnership or to any of the Limited Partners any opportunity of any kind or nature whatsoever, even though such opportunity might come to the attention of or be available to a General Partner through its participation in this Partnership. Each Partner waives any right which he may have against the others for capitalizing on or taking advantage of information learned as a consequence of an association with the affairs of the Partnership.

ARTICLE 14.
CONVEYANCE

14.1) Any deed, mortgage, bill of sale, lease, contract of sale or other instrument purporting to convey or encumber the assets of the Partnership in their entirety or any portion of any real or personal poperty at any time held in

its name, shall be signed by either or both General Partners on behalf of the Partnership, and no other signature shall be required.

ARTICLE 15.
BOOKS, RECORDS, ACCOUNT AND REPORT

15.1) BOOKS OF ACCOUNT. At all times during the existence of the Partnership the General Partners shall keep or cause to be kept by an agent full and true books of account, in which shall be entered fully and accurately each transaction of the Partnership. Such books of account, together with a certified copy of the Articles of Limited Partnership and any amendments thereto, shall at all times be maintained at the principal office of the Partnership and shall be open to the reasonable inspection and examination of all Partners or their duly authorized representatives. Any Partner herein has the right to inspect and copy said books, records, and a list of Unit holders provided that he owns an interest in the Partnership at the time of inspection and that such inspection is made in good faith without any intent to damage the Partnership or any of its Partners in any manner. The General Partners shall, upon reasonable request and payment of copying cost, mail to any partner a list of then Unit holders of the Partnership together with their addresses of record and the number of Units held by each of them.

15.2) EXAMINATION BY ACCOUNTANT. The General Partners shall have the books and records of the Partnership examined and income tax returns prepared for the Partnership by an independent Certified Public Accountant, and a report indicating the respective Limited

Partner's share of net profits or losses and capital gains or losses, all as defined and reflected on said Partnership income tax return shall be distributed to the Partners within ninety days after the close of the taxable year of the Partnership for which such return was prepared.

ARTICLE 16.
BANK ACCOUNTS

16.1) All funds of the Partnership are to be deposited in the Partnership name in such bank account or accounts as shall be designated by the General Partners. Withdrawals from any such bank account or accounts shall be made upon such signature or signatures as the General Partners may designate.

ARTICLE 17.
ASSIGNMENT OF PARTNERSHIP INTEREST: WITHDRAWAL

17.1) GENERAL PARTNER. The General Partners shall not assign, pledge, encumber, sell or otherwise dispose of any rights in specific Partnership property except in connection with such transfer of the rights of all Partners in the same property. The General Partners may, however, at their discretion and without the consent of other Partners, assign, pledge, encumber, sell, or otherwise dispose of their respective shares of the net profits and net losses of the Partnership, if any.

17.2) LIMITED PARTNER. The interest of a Limited Partner may not be assigned, mortgaged, sold or otherwise disposed of, and no Limited Partner shall withdraw or have the right to substitute an assignee in his place except as hereinafter provided:

(01) No assignee or distributee of the whole or any portion of a Limited Partner's interest in the Partnership shall have the right to become a Substituted Limited Partner in place of his predecessor in interest with respect to the whole or any portion of said interest without the written consent of a General Partner.

(02) As a condition of his or her admission as a Substituted Limited Partner with respect to the whole or any portion of the interest of his predecessor in interest, such assignee or distributee shall execute and acknowledge such instruments, in form and substance satisfactory to the General Partners as the General Partners shall deem necessary or desirable to effectuate such admission and to confirm the agreement of the person being admitted as such Substituted Limited Partner to be bound by all of the terms and provisions of the Articles of Limited Partnership as the same may have been amended and then in force. Such assignee or distributee shall pay all reasonable expenses in connection with such assignment and substitution and amendments to the Certificate and Articles of Limited Partnership if necessary or desirable in connection therewith.

(03) The General Partner's failure or refusal to grant such consent shall not affect the validity and effectiveness of any such instrument as an assignment of the right to receive Partnership distributions applicable to such interest under the Articles, provided such instrument is in form satisfactory to the General Partners, and a duly executed and acknowledged counterpart is filed with the Partnership, and, provided further, that the Partnership interest, or any portion thereof, is not being assigned or transferred to a person below the age of twenty-one (21) years or to a person theretofore adjudged to be insane or in-

competent. Any such attempted assignment, transfer, pledge, or hypothecation shall be void and ineffectual and shall not bind the Partnership.

(04) Nothwithstanding any other provision of these Articles, upon the death or legal disability of any Limited Partner, his legal representative shall have all the rights of a Limited Partner for the purpose of settling his estate and such power as the deceased or disabled had to constitute his assignee a substituted Limited Partner. The estate of a deceased or legally disabled Limited Partner shall be liable for all his liabilities as a Limited Partner.

17.3) NON-PERSON LIMITED PARTNER. The authorized representative of a Limited Partner who is not a person upon the dissolution or other cessation of the Limited Partner to exist as a legal entity, shall have all the rights of a Limited Partner for the purpose of effecting the orderly winding up and disposition of the business of such entity and such power as such entity possessed to constitute a successor as an assignee of its interest in the Partnership and to join with such assignee in making application to substitute such assignee as a Limited Partner.

17.4) ELECTION BY GENERAL PARTNERS. The General Partners may elect to treat an assignee who has not become a Substituted Limited Partner as a Substituted Limited Partner in the place of his assignor should it deem, in its sole discretion, that such treatment is in the best interests of the Partnership for any purpose whatsoever. No consent of any of the Limited Partners is required to effect the substitution of a Limited Partner, except that a Limited Partner who assigns his interest must evidence his intention that his assignee be admitted as a

Substituted Limited Partner in his place and execute any instruments required in connection therewith.

ARTICLE 18.
TO WHOM DISTRIBUTIONS MADE

18.1) Each Partner, and any other persons having business with the Partnership, need deal only with Partners named herein or admitted pursuant hereto. They shall not be required to deal with any other person by reason of an assignment or transfer by a Partner or by reason of the death of a Partner, except as otherwise provided in these Articles. In the absence of a transfer in accordance with these Articles of the legal ownership of the Partnership interest of a transferring or deceased Limited Partner, any payment by the Partnership to the one shown on the Partnership records as a Partner or to his legal representatives, or his assignee of the right to receive Partnership distributions shall acquit the Partnership of all liability to any other person who may be interested in such payment by reason of an assignment by the Partner or by reason of his death, or for any other reason.

ARTICLE 19.
VOTING AND MEETINGS

19.1) VOTING. Notwithstanding anything herein to the contrary, the Limited Partners are hereby given the right to vote as hereinafter provided.

(01) TO TERMINATE AND TO AMEND. Upon the vote of the holders of two-thirds of the then outstanding Units the certificate and these Articles of Limited Partnership may be amended or the Partnership may be terminated and its assets sold; provided that no such amendment which

affects the compensation, share of receipts, income or distributions, duties, or obligations of the General Partners under this Agreement, shall be effective or binding upon a General Partner without the prior written consent of such General Partner.

(02) TO REMOVE AND REPLACE GENERAL PARTNERS. Upon the vote of the holders of two-thirds of the then outstanding Units either or both of the General Partners may be removed. If both General Partners are removed, one or more new general partners shall be elected within 60 days following such removal upon the vote of the holders of two-thirds of the then outstanding Units, and the removal of the General Partners shall not be effective until such successor general partner or partners have been elected and have agreed to assume such position. If either or both of the General Partners is removed pursuant to the power of removal herein provided, for any reason whatsoever, the value of the interest of the removed General Partner to share in or receive fees whether or not measured by Partnership receipts, income or distribution, to receive any portion of current receipts, income or distribution and to receive any portion of current receipts, income or distribution and to receive any portion of the proceeds upon sale or disposition of the Property, shall be determined by agreement or by arbitration (the arbiter to be agreed upon; or if none can be agreed upon, one arbiter shall be selected by the removed General Partner, one shall be selected by vote of the holders of a majority of the Units then outstanding and one shall be selected by the two others so selected; the decision of such arbiters shall be final and the fees and expenses of such arbitration shall be paid by the Partnership) and such value shall be paid in cash at the effective date of such removal.

19.2) LIABILITY AND NOTICE. Exercise of voting rights or attendance at a meeting duly called in accordance with this Agreement shall not in any way constitute any Limited Partner a general partner or impose any personal liability on any Limited Partner. Each Limited Partner shall be given not less than ten (10) days written notice of any meeting. The notice shall state the nature of the business to be transacted at the meeting; it shall further state that the Limited Partners have a right to vote on such matters; and it shall state that such vote may be cast either in person or by proxy.

19.3) CALL OF MEETINGS. Meetings of the Partnership may be called by a General Partner and shall be called by it upon the written request of the holders of ten (10%) percent of the outstanding Units.

19.4) AMENDMENTS. Amendments to the Articles may be proposed in writing by the holders of not less than ten (10%) percent of the then outstanding Units.

ARTICLE 20.
TERMINATION AND DISSOLUTION OF THE PARTNERSHIP

20.1) NO TERMINATION UPON CERTAIN EVENTS. The Partnership shall not be terminated or dissolved by the admission of a new Limited Partner or by the withdrawal, expulsion, death, insolvency, bankruptcy or other disability of a Limited Partner.

20.2) TERMINATION UPON SPECIFIC EVENTS. The Partnership shall be terminated and dissolved upon the happening of any of the following events:

(01) The expiration of the term of the Partnership;

(02) The distribution, sale or abandonment of all or substantially all of the Partnership properties and assets;

(03) The General Partner's written election to terminate with the consent of Limited Partners holding a majority of the then outstanding Units.

(04) The retirement, bankruptcy or dissolution of a General Partner, except that, if there exists another General Partner in the Partnership at the time of a General Partner's retirement, bankruptcy or dissolution, that General Partner shall have the right to continue the Partnership's business.

(05) The vote of Limited Partners as provided in Section 19.1 hereof.

(06) If for any reason 14 of the 20 Units authorized by this Agreement have not been sold and the initial payment received therefor within 180 days (the "expiration date") after the date that the first subscriber purchases a Unit.

20.3) DISSOLUTION. Upon an event of termination of the Partnership, as above provided, the General Partner shall wind up and dissolve the Partnership by selling the Partnership assets and distributing the net proceeds therefrom after the payment of Partnership liabilities, to each Partner in accordance with ARTICLE 21 hereof.

ARTICLE 21.
DISTRIBUTIONS ON DISSOLUTION

21.1) ORDER OF DISTRIBUTION. On dissolution the Partnership assets shall be distributed in the following order:

(01) To the payment of the debts to third parties and liabilities of the Partnership including accrued interest and the expenses of liquidation, including a sales commission to the selling agent, if any.

(02) To the repayment of debts to Partners or their affiliates.

(03) To the setting up of any reserves which the General Partner may deem reasonably necessary for any contingent or unforeseen liabilities or obligations of the Partnership or of the General Partner arising out of or in connection with the Partnership. Said reserves shall be paid over by the General Partner to a bank as escrow agent to be held for the purpose of disbursing such reserves in payment of any of the aforementioned contingencies, and at the expiration of such period as the General Partner shall deem advisable, to distribute the balance thereof in the manner provided in this Article and in the order named.

(04) To the payment to Limited Partners and the General Partner in the following manner:

(001) To the Limited Partners an amount equal to $35,000 per Unit then outstanding; however such amount distributable upon dissolution shall be reduced by amounts distributed pursuant to Section 10.3.

(002) To the Limited Partners 75% of the remainder, each Limited Partner to receive a portion in the same ratio as provided in Section 9.3; to the General Partner 25% of the remainder.

21.2) TIME. A reasonable time as determined by the General Partner not to exceed one year, shall be allowed for the orderly disposition of the assets of the Partner-

ship and the discharge of liabilities to the creditors so as to enable the General Partners to minimize any losses attendant upon liquidation.

21.3) STATEMENT AND CANCELLATION. Each of the Partners shall be furnished with a statement prepared by the Partnership's accountant, which shall set forth the assets and liabilities of the Partnership as of the date of complete liquidation and the manner in which the assets of the Partnership, including unused escrow funds, are to be distributed. Upon the General Partners complying with the foregoing distribution plan (including payment over to the escrow agent as aforesaid) it shall cause the cancellation of the Certificate and Articles of Limited Partnership.

21.4) LIMITATION OF REIMBURSEMENT BY GENERAL PARTNERS. Anything in this Agreement to the contrary notwithstanding, the General Partners shall not be personally liable for the return of the capital contributions of the Limited Partners, or any portion thereof, it being expressly understood that any such return shall be made solely from Partnership assets; nor shall a General Partner be required to pay to the Partnership or any Limited Partner any deficit in his capital account upon dissolution or otherwise.

ARTICLE 22.
ELECTION WITH REGARD TO BASIS OF SUBSTITUTED LIMITED PARTNER

22.1) The General Partners, in their sole discretion, may cause the Partnership to make or revoke the election referred to in Section 754 of the Internal Revenue Code of 1954 or any similar provision enacted in lieu thereof.

ARTICLE 23.
POWER OF ATTORNEY

23.1) SCOPE. The General Partners and each of them hereby is constituted and appointed as the attorney in fact for each Limited Partner, with full power of substitution, and with power and authority to act in the name and on the behalf of each Limited Partner in the execution, acknowledgement and filing of documents, including, but not limited to the following:

(01) Certificate of Limited Partnership, as well as amendments thereto, under the laws of the State of Minnesota and in particular, Section 322.24 and 322.25 of Chapter 322 of Minnesota Statutes or the laws of any other state in which such a certificate is required to be filed;

(02) Any certificates, instruments and documents, including fictitious name certificates, as may be required by, or may be appropriate under, the laws of any state or other jurisdiction in which the Partnership is doing or intends to do business in connection with the use of the name of the Partnership by the Partnership;

(03) Any other instrument which may be required to be filed by the Partnership under the laws of any state or by any governmental agency, or which the General Partner deems it advisable to file;

(04) Any documents which may be required to effect the continuation of the Partnership, the admission of an additional or substituted Limited Partner, or the dissolution and termination of the Partnership, provided such continuation, admission or dissolution and termination are in accordance with the terms of this Agreement and;

(05) Any amendment or cancellation of the Certificate as necessitated by the affirmative vote of Limit-

ed Partners pursuant to the requirements of Section 19.1 hereof, notwithstanding a Limited Partner's negative vote therein.

23.2) EXERCISE. The power of Attorney granted by each Limited Partner to the General Partner:

(01) Is a Special Power of Attorney coupled with an interest and is irrevocable;

(02) May be exercised by a General Partner for each Limited Partner by a facsimile signature of the General Partner or by listing all of the Limited Partners executing any instrument with a single signature of the General Partner acting as attorney-in-fact for all of them;

(03) Shall survive the delivery of an assignment by a Limited Partner of the whole or any portion of his interest; except that where the assignee thereof has been approved by a General Partner for admission to the Partnership as a substituted Limited Partner, the Power of Attorney shall survive the delivery of such assignment for the sole purpose of enabling a General Partner to execute, acknowledge and file any instrument necessary to effect such substitution.

23.3) FURTHER ACTION. Pursuant to the Power of Attorney granted by the Limited Partners to the General Partners as hereinabove described, each Limited Partner authorizes said attorney to take any further action which said attorney shall consider necessary or convenient in connection with any of the foregoing, hereby giving said attorney full power and authority to do and perform each and every act and thing whatsoever requisite and necessary to be done in and about the foregoing as fully as said Limited Partner might or could do if personally present, and hereby ratifying and confirming all that said attorney shall lawfully do or cause to be done by virtue hereof.

ARTICLE 24.
LITIGATION

24.1) CONTROL OF LITIGATION. The General Partners shall prosecute or defend actions at law or in equity as may be necessary to enforce or protect the Partnership's interests. No Limited Partner shall be liable (i) as a General Partner unless, in addition to his rights and powers as a Limited Partner, he takes part in the control of the business, or (ii) to the Partnership or to a General Partner unless a liability of the Partnership or of a General Partner, as the case may be, is founded upon the unauthorized activity of such Limited Partner in attempting to take part in the control of the business.

24.2) FAILURE TO COMPLY WITH STATUTE. Should there at any time be a final decree, judgment or decision of any court, board or authority having jurisdiction in the premises holding that the Partnership was not validly formed as a Limited Partnership under the provisions of Minnesota Statutes, Section 322.02, in that there had not been substantial compliance in good faith with the requirements of such section, then, and in that event only, the Limited Partners and their Assignees hereby, and by these presents, renounce their interest in the profits of the business, or other compensation by way of income. In such event, the General Partners shall provide for the satisfaction of all claims and known creditors of the Partnership, first, out of any insurance proceeds available therefore, and, second, out of the assets and income of the Partnership. Should there be Partnership assets remaining after provision has been made for the satisfaction of all claims, the General Partners will either have a new Certificate and Articles of Limited Partnership properly executed and

filed in the office of the Register of Deeds of Olmsted County, Minnesota, and continue to carry on the business of the Partnership, or it will dissolve and terminate the Partnership, distributing the remaining assets of the Partnership in accordance with the provisions of these Articles.

ARTICLE 25.
AMENDMENT OF LIMITED PARTNERSHIP CERTIFICATE AND ARTICLES

25.1) The Certificate of Limited Partnership of this Partnership shall be amended whenever:

(01) There is a change in the name of the Partnership or the amount or character of the contribution of any Limited Partner;

(02) A person is substituted as a Limited Partner;

(03) An additional Limited Partner is admitted;

(04) A person is admitted as a General Partner;

(05) There is a change in the character of the business of the Partnership;

(06) There is a false or erroneous statement in the Certificate;

(07) There is a change in the time as stated in the Certificate for the dissolution of the Partnership or the return of a contribution;

(08) A time is fixed for dissolution of the Partnership or the return of a contribution, no time having been specified in the Certificate; or

(09) The Partners desire to make a change in any other statement in the Certificate in order that it shall accurately represent the agreement between them.

ARTICLE 26.
MISCELLANEOUS PROVISIONS

26.1) NOTICES. All notices provided for in these Articles shall be directed to the parties at the addresses indicated in the instrument of execution as set forth opposite their respective names or at such other places as the Partnership shall be so notified in writing by the Partners and to the Partnership at its principal office by registered or certified mail.

26.2) GOVERNING LAW. All questions with respect to the construction of these Articles and the rights and liabilities of the parties shall be determined in accordance with the applicable provisions of the laws of Minnesota.

26.3) BINDING. These Articles shall be binding upon all of the parties and their assigns, successors in interest, personal representatives, estates, heirs, or legatees.

26.4) INTERPRETATION. When the context in which words are used in these Articles indicates that such is the intent, words in the singular number shall include the plural and vice-versa, and words in the masculine gender shall include the feminine and neuter genders and vice-versa.

26.5) VALIDITY. In the event that any provisions of these Articles shall be held to be invalid, the same shall not affect in any respect whatsoever the validity of the remainder of these Articles.

26.6) CAPTIONS. Any section or paragraph titles or captions contained in these Articles are for convenience only and shall not be deemed a part of the context of these Articles.

26.7) AGREEMENT IN COUNTERPARTS. These Articles may be executed in several counterparts and all so executed shall constitute one agreement, binding on all the parties hereto, notwithstanding that all the parties are not signatory to the original or to the same counterpart.

26.8) ENTIRE AGREEMENT. These Articles contain the entire understanding between the General Partners and Limited Partners and supersede any prior written or oral agreements between them respecting the within subject matter. There are no representations, agreements, arrangements or understandings, oral or written, between and among the Partners hereto relating to the subject matter of these Articles which are not fully expressed herein.

IN WITNESS WHEREOF, the parties hereto have signed this instrument as of the day and year first above written.

IN THE PRESENCE OF: GENERAL PARTNERS
ALOTEL,
_____ _____ INCORPORATED

_____ By: _____

_____ By: _____

_____ _____ Its Secretary Seal

_____

B. J. Loftsgaarden

STATE OF MINNESOTA)
) SS.
COUNTY OF)

On this — day of _____ , 1972, before me, a notary public within and for said County personally appeared _____ and _____ to me personally known, who, being each by me duly sworn did say that they are respectively the President and Secretary

of the corporation named in the foregoing instrument, and that the seal affixed to said instrument is the corporate seal of said corporation, and that said instrument was signed and sealed in behalf of said corporation by authority of its Board of Directors and said President and Secretary acknowledged said instrument to be the free act and deed of said corporation.

_____

Notary Public

STATE OF MINNESOTA)
) SS.
COUNTY OF)

On this —— day of ————, 19—, before me, a notary public personally appeared B. J. Loftsgaarden, personally known to me, who stated that he executed the foregoing instrument as his free act and deed.

_____

Notary Public

ALOTEL ASSOCIATES
INSTRUMENT OF EXECUTION

1. UNIT SUBSCRIPTION — The undersigned applies for and agrees to purchase the number of Units set for above his signature and hereby tenders full payment for such Units (minimum subscription one Unit).

2. ADOPTION — The undersigned hereby specifically accepts and adopts each and every provision of the Articles of Limited Partnership (the "Articles") of ALOTEL ASSOCIATES.

3. REPRESENTATIONS AND WARRANTIES — The undersigned hereby represents and warrants that:

a. He is aware that no federal or state agency has made any findings or determination as to the fair-

ness for public investment, nor any recommendation nor endorsement of Units;

b. He recognizes that the Partnerssip has only recently been organized and has no financial or operating history and, further, that the Units as an investment involve a high degree of risk;

c. He is aware that there is no public market for Units and that it may not be possible readily to liquidate his investment;

d. He understands that the Units have not been registered with the Securities and Exchange Commission or under the securities laws of any state. The Units are being acquired for investment purposes and not for purposes of resale or other distribution;

e. He has carefully reviewed the Articles and, in making an investment in the Partnership, has relied solely thereon and on his independent investigation;

f. He has a net worth in excess of $200,000.00; or some portion of his income is subject to Federal and State income tax at a rate of 50% or more;

g. He is a resident of the State of Minnesota.

4. POWER OF ATTORNEY — The undersigned hereby makes, constitutes and appoints Alotel, Incorporated and B. J. Loftsgaarden or either of them his true and lawful attorney in fact, with full power of substitution, for the purposes and to perform in the manner set forth in Section 23 of the Articles.

IN WITNESS WHEREOF, the undersigned has executed this Instrument of Execution this — day of ————, 1973.

Number of Units (One Unit Minimum)
Total Price:

Payment Accompanying this Instrument

_____

Signature

REGISTRATION INFORMATION

Name(s) in which Units are to be registered

Address (including zip code)

Tax Identification or Social Security Number

STATE OF _____

COUNTY OF _____

On _____ before me, the undersigned, a Notary Public in and for said State, personally appeared _____ known to me to be the person whose name is subscribed to the within instrument and acknowledged that he executed the same.

WITNESS my hand and Official Seal.

_____

Notary Public

(NOTARY PUBLIC SEAL)
My Commission Expires

INVESTMENT AND NON-DISTRIBUTION LETTER

Alotel, Incorporated
B. J. Loftsgaarden
2361 Highway 36
St. Paul, Minnesota

Re: Units of Limited Partnership
Alotel Associates

Gentlemen:

The undersigned, proposes to purchase Units of Limited Partnership in Alotel Associates and has been advised that said Units of Limited Partnership to be issued to him pursuant to such subscription have not been registered under the Securities Act of 1933 or the securities laws of any state. The undersigned has further been advised that the Units to be issued upon acceptance of such subscription will be issued pursuant to exemptions from said securities laws. It is understood that the reliance of Alotel, Incorporated, B. J. Loftsgaarden, Alotel Associaates, and all of their officers, directors and promoters on these exemptions from registration are in part dependent upon the representations made and by this letter.

With these matters in consideration, the undersigned hereby represents and warrants to Alotel, Incorporated, B. J. Loftsgaarden, Alotel Associates and to each person who may be an officer, director, promoter or person in control of any of said entities that the Units of Alotel Associates subscribed for are to be acquired for investment purposes and not for purposes of resale or other distribution. The undersigned has no present intention to sell, pledge, assign, give, or otherwise dispose of or distribute any of the Units of Limited Partnership which will be received upon acceptance of said subscription.

In order that you may to the greatest extent possible assure yourself of the intent of the undersigned as herein expressed, it is agreed that a legend may be placed on each certificate representing such Units of Limited Partnership, to the effect that the Units have not been registered and that no interest therein may be sold or otherwise disposed of in the absence of registration under the Securities Act of 1933 and any applicable state securities laws, or of an opinion of counsel satisfactory to the Partnership and its General Partner that such registration is not required.

Dated: _____ _____

Court's No. 2

April 7, 1980

Mr. B. Jerome Loftsgaarden
2540 Cleveland Avenue North
St. Paul, Minnesota 55113

Re: Randall v. Loftsgaarden
Civil No. 4-76-82
Our File No. 11,186-001

Dear Mr. Loftsgaarden:

By this letter, Dr. William C. Randall again tenders to you his limited partnership unit in Alotel Associates, a Minnesota limited partnership, in yet another attempt to rescind his purchase. He demands that you return the monies which he paid out for his limited partnership unit.

Very truly yours,

Robert A. Brunig

cc: Dr. William C. Randall
Laura S. Underkuffler, Esq.
Bradley G. Clary, Esq.
Terence M. Fruth, Esq.
George G. Seltz, Esq.
Theodore K. Abe, Esq.

Court's No. 3

FREDRIKSON, BYRON, COLBORN,
BISBEE & HANSEN
A Professional Association

4744 I D S Center
Minneapolis, Minnesota 55402
Telephone (612) 339-8331

Moorhead Office
200 F M Center
Moorehead, Minnesota 56560
Telephone (218) 236-0400

Jack W. Hanson
John M. Koneck

Of Counsel
Hugh V. Olson

Harold M. Fredrikson
John P. Byron
Earl P. Colborn, Jr.
Bertin A. Bisbee, Jr.
John M. Palmer
Richard R. Hansen
Jerome B. Pederson
Robert G. Weber
Robert P. Sands
Keith A. Libbey
Jerome S. Rice
Terence M. Fruth
John H. Stout
James L. Baillie
R. Bertram Greener
Warren E. Mack
John L. Powers
Quentin T. Johnson
Timothy M. Heaney
Frederick E. Finch

Thomas W. Garton
Judith L. Dowdle
John A. Satorius
Michael A. Stern
Neil A. Weikart
William J. Brody
John H. Merkle
John A. Grimstad
Eric S. Anderson
David R. Busch
Marsha A. Freeman
Thomas S. Fraser
David C. Grorud
Jack P. Helms
Karen R. Ecklund
Konrad J. Friedmann
John J. Erhart
John G. Kost
Kathleen A. Hughes

Patent Counsel
James R. Haller
Steven G. Parmellee

May 8, 1980

Mr. B. Jerome Loftsgaarden
2540 Cleveland Avenue North
St. Paul MN 55113

Re: Dr. Roger E. Austin, et al v. B. J. Loftsgaarden, et al

Dear Mr. Loftsgaarden:

By this letter, Dr. Roger E. Austin and Dr. Tom W. Anderson each tender to you their units and Dr. Myrel A. Neumann tenders to you his 1½ unit of the limited partnership Alotel Associates, a Minnesota limited partnership, in another attempt to rescind their purchases. They demand that you return the monies which they paid out for their limited partnership units.

Sincerely yours,
/s/ John A. Grimstad

JAG/rkf

UNITED STATES DISTRICT COURT
STATE OF MINNESOTA
FOURTH DIVISION

EXCERPT FROM DEPOSITION

Deposition of Anthony Pikul

DIRECT EXAMINATION

* * *

By Ms. Underkuffler:

(p. 18) Q Have you come to a conclusion or do you have an opinion as to what the market value of the partnership units was (p. 19) at the time they were sold?

A Yes, I think so. Well, on the basis of the Offering Memo and, of course, the Findings of Fact it is my opinion that the market value at the time that these units, Alotel Associates, were sold was zero.

Q Could you explain to me what facts you used to come to this conclusion? What particular facts, or how did you arrive at the conclusion that they were worth zero?

A Well, the Offering Memorandum provides certain information. For example, the land lease or the ground lease was to have been 40 years; subsequently it turned out to be just a 15-year lease and, as far as I know or have been able to determine, there was no option to buy. And that is a defect, I think, in the project because hotels require long-term leases.

Q Okay. Were there any other facts that led you to the conclusion that the units were worth zero?

A Apparently there was some miscalculation or defect in the financing plan. Instead of a firm rate of interest on the chattel mortgage or the loan which was sup-

posed to have paid for the furniture, instead of a firm rate of 9½ we ended up with a floating rate which was tied to the prime rate, and so we ended up with a very high interest rate. This apparently was not disclosed in the Offering Memorandum.

(p. 20) Q Were there any other factors that—

A Yes. There was no long-term commitment for the take-off mortgage; that is, the long-term mortgage that would follow the completion of the building until pretty late in the operation. And that, again, was tied to a floating rate certainly points above the prime. It was also for a very short period—only 12 years—with a balloon payment. This is sort of contrary to the typical financing of a hotel, which is usually a 20 or 30-year loan with a fixed rate.

Q Were there any other facts you considered important in this?

A The construction cost, carrying cost, was rather high. I believe that was brought out to be a firm rate and ended up as a floating rate I think it was four points above the prime. So by the time the project was completed I think they were paying 15 or 16 percent interest, which is, of course, a little unusual and quite high.

Q Okay. Were there any other factors?

* * *

A Well, the construction time period I think was probably (p. 21) understated because my recollection is that the memorandum said something like six or seven months and it turned out to be a year, which is more typical. I believe those are the principal factors.

Q Okay. Just for the record, the two documents you are referring to are Judge Larson's Findings of Fact and Conclusions of Law and Order dated —

A August 15th, 1980.

Q And a copy of the Offering Memorandum?

A That's correct.

Q So those were the primary factors that led to your conclusion that the units were worth zero at the time of selling?

A Yes. Because if you combine all these factors it would appear to me that the chances of success of such an enterprise would be practically nil, would be very poor.

Q Okay. When you are talking about the chances of success, how are you defining success?

A Well, I'm thinking of an operation that is completed on time, which is financed properly and has a sufficiency of working capital—which, incidentally, was another deficiency.

Q Could you explain what the deficiency was with regard to working capital?

A Well, working capital for a hotel of this size in my (p. 22) opinion should have been approximately $2,000 a room, or roughly $350,000. We had, I think, at one time $100,000, but it was further reduced because of other expenses to $60,000. So there was a deficiency of working capital. This, of course, places a burden on the partners and, unless they are very rich, of course, it makes it difficult to make the operation go.

Q When you say that when you combine these factors the chance of success was practically nil; when you define

success do you mean that it is a going operation for X number of years? Or do you have a more definite idea as to what you mean by that?

A Well, except for the early period where you are in a loss posture, sooner or later you reach a break-even point and then you become a viable operation, and producing profits is the bottom line. And I understand from the Findings of Fact that this thing was foreclosed and it never did get started.

Q Do you have an estimate as to when a hotel project like this should reach a break-even point?

A Yes. The break-even point typically is around 18 months, or in the second year. So you have a loss year and then you have basically a break-even year and the third year is usually the stable or full-time profitable year. Now there can be other things happening, but this is typically (p. 23) what we look at.

Q When you stated that the units were worth zero at the time of sale, you have already explained that you base that belief on the opinion that the chances for success were practically nil as far as the hotel venture becoming a going concern. Were there any other reasons why you considered the partnership units to be worth zero? In other words, are you telling that just to the hotel's success or are you telling that to something else in addition?

A Well, there was one other factor that I haven't mentioned which bothered me, and that is the fact that we were dealing with an individual who was, perhaps, less than honest.

Q Okay. Could you explain what you mean by that?

A Well, he made a number of statements which turned out to be misstatements. And he, I presume, was the author of this Offering Memorandum. And another thing the Offering Memorandum stated was that the general partner would be financed to the extent of 15 percent of the total investment of the limited partners when. in fact, it was never financed. That appears among the findings here. I think the project had a lot of strikes against it.

Q When you are referring to someone here was less than honest, I take it you are talking about Mr. Loftsgaarden?

A Yes.

(p. 24) Q Are you personally acquainted with Loftsgaarden?

A I know him a little bit, yes; not very well.

Q Are you basing your opinion that he is less than honest purely on basically these two documents, or on some other factors?

A Primarily on these documents.

Q How does your belief that he was less than honest affect the value of the units?

A Well, there is a matter of credibility here in how you are dealing with a person in a business transaction. In other words, are you going to be dealing straightforward and aboveboard, or are you going to be having some little deals on the side and that kind of thing. Indicated

in these documents is the fact that he set up an architectural company where he was going to participate 30 percent, and apparently he was sole stockholder of another company, PDRC, which was handling the land lease. I get the opinion that there was some side deals here that were not fully disclosed, so I guess I'm going to the matter of disclosure primarily.

Q How does that failure to disclose have any direct pecuniary impact on the value of the units? You have enumerated specific things that had some pecuniary impact on a particular area. Are you saying this is a separate area? In other words, are you saying that the alleged dishonesty (p. 25) had an impact per se?

A Well, I wouldn't deal with a person to begin with if I knew he lacked in integrity, essentially. I would be afraid to deal with him. And that's part of my opinion, yes. But I think the project was poorly conceived and badly financed and there were some other serious defects aside from Mr. Loftsgaarden. But I think the big weight of it was the bad financing and bad planning. I think that was the basic reason. That's just another straw.

* * *

(p. 26) Q When you said that these factors in your view made the chances of success of this project practically nil, what assumptions were you working on with regard to that statement? In other words, you had to make certain assumptions before you could evaluate these factors in the context of a project like this. Could you describe for me what your assumptions were?

* * *

Q Did you make any assumptions and, if so, what were those assumptions?

A No. I was working primarily from the statements of fact (p. 27) and projections.

Q So you limited yourself —

A Pretty much to what happened in those, and then the subsequent developments which revealed something else.

Q Okay. Well, maybe we can take those one by one. The first thing you mentioned was the land lease and you said that it was supposed to be 40 years and, in fact, it was something else and in your view this affected the value of the units.

A Well, yes, because I think the ground lease usually — In fact, I'm surprised that they ever got a long-term loan because the ground lease is usually subordinated to the long-term financing and has to be firm and usually has to be over the lease itself. Most of them you'll find 99 years, 40 years, 50 years—covering a long period of time and covering what is normally the period of a mortgage. Mortgages on hotels are not 10, 12 or 15 years, but usually 20, 25 years; and the longer the better from a financing standpoint, you see. And I'm looking at the great risk we have here. We've only got a 12-year long-term mortgage, which, of course, is an extremely short time. But it would be difficult to go to somebody else, apparently, and get a longer mortgage with a lease that's such a short period, you see.

Q So you are saying that this lease would have been material (p. 28) insofar as any attempt to obtain a lower mortgage at a later date?

A Yes. Well, at any date. And apparently it may have affected this; I'm not sure. I'm not going to assume anything in this case. There was a 25-year pay-off in terms of the monthly payments which were, you know, the same month after month. But then you have a balloon at the end of 12 years. Whether or not at that point you could get a long-term refinancing, I'm not sure. But unless that lease defect was corrected, you see, your chances weren't very good. In other words, you would have a financial crisis coming up.

Q Do you have any information with regard to this case as to whether any other financing was ever sought other than the initial —

A No. No, I'm not familiar with what happened beyond this point.

Q Are there any other repercussions as to this land lease problem that formed the basis of your opinion, other than the financing problem?

A I don't know if I can answer that because I haven't seen the lease. These ground leases usually have certain provisions that I have counseled on with investors. For example, the rental rate; if we can get it fixed, fine. If it's going to escalate in the escalation clause we have (p. 29) to be careful about that.

Q But you don't have any information right now as to any of that?

A No. I haven't seen the lease.

Q Okay. With regard to the floating rate of interest; you mentioned that was another factor in your

analysis, the fact that the interest rates were floating on the loan as opposed to being fixed.

MR. GRIMSTAD: Which loan?

A The construction loan was one and the furniture loan was another. This was very unusual in this type of investment.

Q Did you make any calculations as to exactly what financial impact these floating interest rates had on this particular project? Or was it more of a generalized opinion on this?

A Well, I made some quick mental calculations, but I didn't get to the point of — Because I haven't seen any results. I would have to see the first year operation results and some others to make any final calculations. But based on the typical financing structure, these are very heavy carrying costs, as these documents indicate, and created some loan situations and other problems, apparently.

Q What is the typical financing structure, in your view?

(p. 30) A Well, the typical financing structure is, for one thing, you have some firm rates. Usually a construction loan may be a point or two higher than your long-term loan, but it's usually a firm rate. Of course, things have happened since that time. Things have changed. But in the early '70's our rates were at 6 or 7 percent and loans were not hard to get. Now, I don't know what happened here but . . .

Q Okay. When you said you did some quick mental calculations can you tell me what those are? Or did they really not enter into your overall conclusion?

A No, I didn't use any figures in the overall picture. but I knew that they were excessive.

Q What should they have been in your view? You mentioned 6 to 7 percent. Is it your view that the construction loan and the chattel loan and all these things should have been in that range? Or what should they have been in your view?

A Well, the lower the better. I don't know if I should speculate here, but I think somewhere around 7 or 8 or 9 percent on a fixed basis would have been compatible. But not 15 or 16. You see, that floating rate kind of killed you.

Q Okay. And when you were saying 7, 8 and 9 percent you were referring that to this time period of 1972 and 1973? (p. 31) In your experience that is what people were getting in that time period for loans of this type?

A Well, I think they were basically lower. I was giving you the high side. There were some 6 percent loans, I believe, in those days; 7 percent loans. But I'm telling you what is compatible with the operation. 8 or 9 percent would not have killed the operation.

Q Would you advise someone against investing or would you deem a project like this to be questionable merely because of the floating rates? I mean, is that enough in your view to make the entire project questionable?

A Well, that depends on other resources of the investors. In this particular case, working capital was pretty low. I think it depends on how much working capital is

available and what the resources are of the individual investors. If there are unlimited resources, then they could probably weather the storm. But this was not the best situation from the average viewpoint.

* * *

(p. 36) Q When you noted that the construction time period was also a factor; that it more typically is a year and in this case it was less than a year and you considered that to be a factor in your evaluation, could you explain to me how that impacted on the value of the units?

A Well, I think in two aspects: One is the dishonesty; he didn't tell the investors the truth. And, secondly, there is a carrying cost involved which was greatly increased by the floating rate. Instead of a seven-month period of construction you had, I believe, a twelve-month period. So it hurt financially.

Q You also mentioned several times that the working capital was less than what you think it should have been. Can you explain to me exactly how that translated or partially translated into a zero value on the date of sale? In (p. 37) other words, even if it was undercapitalized that doesn't necessarily make the units worthless, so could you please explain to me how that fit into your picture, the whole picture of your analysis?

A I don't think I can answer that directly because that's only one segment of the overall picture. The overall picture when you put all these factors together, it appears to me, makes the investment highly suspect. And taken together, each one of these things — I don't know if you can separate one from the other.

* * *

(p. 38) Q Mr. Pikul, did you come to any conclusions as to whether any of these investors received any monetary benefit from their investment in Alotel Associates?

A Well, the only conclusions were those that appear in one of the briefs. I guess there were some tax benefits, if that's what you're referring to.

Q Are you of the opinion that they did receive tax benefits?

Well, I'm not sure. But there was some statement in one of the briefs that there were some tax benefits. I haven't seen any tax returns so I don't know if I can make a conclusion.

Q So your analysis really didn't cover that aspect of the problem?

A No.

Q And when you say they were worth zero, that is apart from whatever tax ramifications may or may not have existed?

(p. 39) A Not exactly because it seems to me that there are certain bonuses or benefits. This goes to the second issue, I believe, where we define a tax shelter; whether this was or was not a tax shelter. But an investment of this type, a hotel investment, does have depreciation charge-offs and a loss usually in the first two years, which may become deductions depending on the structure of the operation. In this type of company or operation there would be some losses deducted on their individual income tax returns, but I consider these as normal and side issues or side benefits or bonuses rather than something of monumental value.

• • •

Q With regard to, you said the second issue which you already touched on was whether or not Alotel Associates was a tax shelter. You listed that as the second issue which you were to address.

A Yes, that's what I was asked to do.

Q Have you come to a conclusion about that issue?

A Yes. I do not believe it was a tax shelter. A hotel investment of this type is a long-term investment. As I (p. 40) mentioned, the depreciation does protect the income and provide deductions against the operating profits and there usually are some tax benefits in the early years, but the basic vehicle is a long-term investment and typically kept until 10 years or later, until depreciation is consumed, and at that time it is then sold for a capital gain.

Q Do you know whether the project in this case was sold for a capital gain?

A No, I'm not familiar with what happened beyond what's here.

Q How would you define a tax shelter? When you were answering this inquiry how did you define it?

A It's probably easier to describe one than to define it, but basically a tax shelter is a vehicle or arrangement, the principal purpose of which is to obtain tax deductions or offsets to a high tax bracket investor's income. Shall I give an example?

Q Sure.

A Typically in oil wells we have a depletion allowance and this provides substantial deductions and, of

course, quite frequently these types of investments are high risk because in the case of oil wells you have dry holes. But commensurate with the high risk, of course, is the possibility of making a strike. So there is a possibility (p. 41) of gain, obviously.

Q Okay. And in this case why do you think that this was not a tax shelter? Are you saying that it didn't meet this principal purpose?

A That's right. The principal purpose of this hotel was a profit-making enterprise, a long-term investment, which was to produce not tax deductions but taxable income.

Q Okay. Mr. Pikul, you are not a lawyer? Is that correct?

A No.

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UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA
FOURTH DIVISION

CIVIL NO. 476-82

Dr. Roger E. Austin, Dr. Thomas W. Anderson, Dr. Myrel A. Neumann and Dr. William C. Randall v. B. J. Loftsgaarden, et al.

EXCERPT FROM TRANSCRIPT OF PROCEEDINGS
TESTIMONY OF JOHN M. CARLSON

* * *

(p. 39) JOHN M. CARLSON, being duly sworn, testified as follows:

THE CLERK: Please state your full name for the record.

THE WITNESS: My name is John H. Carlson, I live at twenty-six-o-nine East Eighteenth Avenue, North St. Paul, Minnesota.

MR. FLASKAMP: I might state, your Honor, that prior to the hearing, in accordance with the meeting that we had here, I think it was last month or whatever, that we had gone over, between our accountants, I guess, and the accountants in the office, of the attorneys for Austin, Anderson and Neumann, and I believe it is stipulated by and between at least those parties that the figures on Tables One, Two, and Three—that will be introduced—are accurate.

Am I correct on that?

MR. GRIMSTAD: That is correct.

(p. 40) We could also put in the record the total of those amounts because it is not self evident from that exhibit how the totals are to be derived.

MR. FLASKAMP: Okay. We can cover that with him.

MR. GRIMSTAD: All right.

MR. FLASKAMP: Then, if you have some question about it, you can just put it in.

THE COURT: Well, now you are only getting a stipulation from three. How about Mr. Brunig?

MR. FLASKAMP: He didn't agree, your Honor.

THE COURT: Well, let's see why he didn't agree then, because what's the use of having one stipulated and one unstipulated amount?

MR. FLASKAMP: Well, we have four plaintiffs, and three of them agreed, but Mr. Brunig did not agree because of the seventy-five hundred treatment that we've gone through.

THE COURT: All right, I've got it.

MR. FLASKAMP: That we just went through here now.

THE COURT: Go ahead, I understand it.

DIRECT EXAMINATION

MR. FLASKAMP:

Q All right, state your full name please?

A John N. Carlson.

Q And where do you live, sir?

A 2609 East Eighteenth Avenue, North St. Paul.

(p. 41) Q What is your occupation?

A I am a certified public accountant in the state of Minnesota.

Q Will you give the court your educational background, sir?

A I graduated from the University of Minnesota in 1950, with a B. B. A.

Q And will you give us your work history since nineteen fifty?

A I have been in public accounting ever since nineteen fifty, for ten years with a firm in St. Paul.

Q The name of that firm?

A Taylor, McCaskill and Company.
And since that period I have been on my own account.

Q Are you a certified public accountant?

A Yes, I am.

Q How long have you been certified?

A Since nineteen fifty-five.

Q Okay?

A Twenty years less than Mr. Essene.

THE COURT: Off the record.

(Remarks off the record).

THE COURT: Back on the record.

MR. FLASKAMP:

(p. 42) Q And you have been basically then—you have no other occupation?

A No.

Q Now have you examined the tax returns of Randall, Anderson, Austin and Neumann at length?

A Yes, for the years 1973 through '78, and two additional years, I believe it was, for Dr. Randall.

Q And have you examined those returns in connection with this lawsuit and in connection with the Alotel partnership?

A That is correct.

Q And have you prepared certain summaries that we've offered as Plaintiff's Exhibits 1-A, -B, and -C?

A. Yes.

MR. FLASKAMP: I am going to offer those exhibits at this time.

MR. BRUNIG: Your Honor, I am not sure what A, B, and C are.

MR. FLASKAMP: It's the Tables One, Two, and Three.

THE COURT: Go ahead.

MR. FLASKAMP: I don't know what Mr. Brunig said about them.

THE COURT: All right, go ahead.

MR. BRUNIG: Your Honor, we're going to object to the total damages.

I don't believe that that's a summary.

(p. 43) That's conclusion. That's part of 1-C.

And in addition it is my understanding that that is at variance with the Court's ruling on what damages are.

THE COURT: Are you referring to Exhibit C?

MR. BRUNIG: Exhibit C.

THE COURT: Okay.

Well, you can prove that up, or give it a try, anyway, so I'll receive A, and B, and reserve C.

MR. FLASKAMP: All right.

The offer of C is made, your Honor, as his opinion.

THE COURT: What?

MR. FLASKAMP: I gather—you made a premature ruling here, basically—you are going to rule at the end of the case, too—but we're putting the testimony in here.

In other words, what he feels are damages may be different than yours, but that's his opinion.

That's the reason it is on there.

THE COURT: Okay. Well let's do these two first. Then I can understand what he's doing when he talks about it.

MR. FLASKAMP:

Q All right, let's go to Table One, if you will?

A All right.

Q Would you go thr igh what that particular table shows us? We can read the numbers and we can read the names, but tell us what you have done. Take out Doctor Randall for (p. 44) example?

A Utilizing the returns as filed, or in the event that there was a revenue agent's report available which changed those, I selected from the various years the numbers which applied only to the Alotel, including then in those returns. These items that are listed here are the items as reflected in the returns or the revenue agents' reports, which applied to Alotel.

Q And what is Schedule E there?

A Schedule E would be the Schedule E on the form 1040 in which the partnership reports its net ordinary loss or gain.

Q And this is Doctor Randall's share of that?

A That is right.

Q What about Schedule D?

A Schedule D. would reflect the capital gains treatment from an Alotel item, how much was included in the net taxable income from the Alotel reporting.

Q And how about 4797, what is that?

A Apparently in some of those years there must have been some internal transaction within the partnership which was assigned to the individuals, and that would carry over again as an ordinary taxable item on his return.

Q How about investment credit?

A Investment credit had been reported by the partnership to the partners and included in their individual (p. 45) return for whatever qualifying asset was acquired in the partnership.

Q And how about "Cr. recapture"?

A That would be a credit recapture in the event that the partnership terminated the ownership of one of those assets on which it had earlier enjoyed the investment credit prior to the earned period.

Q Now are these actually from the returns themselves sir?

A These are from the returns, or as I said from the revenue agents report, if that overrode the return.

Q All right. Now go to Table Two, if you will, and tell us what you have done there?

A Well, in Table Two what I have done is summarized my work in going through the individual returns, or the revenue agents reports, for each of the years involved, and making a calculation as to what the tax liability would have been had the Alotel times been eliminated from that year, giving effect to the obvious additional items, such as the limitations that would arise on sales taxes from the table, the deduction for that, the medical deductions, the cross deduction of the federal taxes on the state return, and the state on the federal, and this would show me the net tax benefit that had been enjoyed by the partners for each of these years by having Alotel items included in their returns.

(p. 46) Q Now is this also directly from the return?

A That is correct.

Q Now for example let's take Doctor Randall's column and the net reduction from federal income taxes. As far as the money saved in tax benefits to Doctor Randall or the individuals like him on that summary, each of those years, how would you categorize that sum from an accounting stand point?

A You mean as relates to the investor?

Q Yes.

A I would consider that to be a reduction in his capital investment.

Q All right. And that would be true for Randall, Anderson, Austin, and Neumann?

A That is true.

Q All right. Now going down to the second section of the column two, have you done the same thing with the state return that you have done with the federal returns?

A I have.

In the case of Mr. Randall there is one qualification there—possibly some on the others, but I think it's only Mr. Randall where I issue it, and I did not have a revision of his 1978 state return since I did not have any audit report similar to the federal audit report, so I went back and calculated what I thought it would have been had the state also included the same changes as the federal.

(p. 47) Q Have you had a chance to look at the actual return that he filed here recently?

A No.

Q All right. This is your calculation of what you believed would occur?

A That is right.

THE COURT: How far off did he come?

MR. FLASKAMP: I don't know.

Q You haven't looked at it, have you?

A Well, in looking at the net difference between myself and Mr. Essene, I can't believe that we're very far off

on the actual tax numbers overall for the period. We may have some differences—we do have differences by year.

THE COURT: Let me ask you:

When you say that you regarded these items in the first column, like under "Randall" there, as a reduction in his capital investment, that is consistent with the ruling of the Eighth Circuit, what you are saying is?

THE WITNESS: I don't really know, Judge, what the Eighth Circuit has said.

I am not that familiar with that part of the case, as I said.

What I am saying, from an investor's point of view, generally when you look at something which is brought to you as a tax shelter or something, you say, you know, the investor (p. 48) says, "What have I got invested in this," at the end of the first year, the second year, and you always take into consideration the tax savings because that's part of his decision to enter into the investment in the first place.

THE COURT: Well that's in effect what the Court of Appeals said isn't it?

MR. FLASKAMP: I believe so, your Honor.

THE COURT: Okay, go ahead.

MR. FLASKAMP: All right.

Q Then going down to the bottom one where you have permanent tax reductions after recapture, will you tell us what you have here?

A That's a summary of the items up above, combining the federal and the state tax savings in the first two

lines and—excuse me—on the first line is the federal savings, and on the third line is the state savings, in actual taxes, from the filings that were submitted.

The times on the second and fourth line are actually the carry over of the tax benefit which would have arisen in later years from the additional taxes that were paid by these partners in 1973 when they had recapture.

Q All right. Now I am at Table Three, your Honor, so—which is a compilation of the other two.

MR. FLASKAMP: Maybe I could amend Table Three by saying, "Summary of Defendant's Claimed Damages," with the (p. 49) heading, whatever—

THE COURT: Yes.

MR. FLASKAMP: —I think it is self evident anyway, but—

THE COURT: Well, why don't you just change the name when you get time?

MR. FLASKAMP: All right.

Q Go to Table Three, then, if you would and will you tell us what you have done with Table Three, Mr. Carlson?

A Table Three then is a carry over from Exhibit B of the tax savings which were realized by each of the partners.

And following that are the investment totals as they were furnished to me.

And the difference between the two winding up showing the net damage or benefit in each case that the investor or partner had with relationship to his tax savings and his investment, his original investment.

Q All right. Now in connection with your figures, you have been here when Mr. John Essene testified, did you not?

A Yes.

Q And I want to discuss with you your opinion as to the validity of certain assumptions.

First, that fifty-four percent number that he used. Do you have an agreement with him on that or do you not?

A Well, I think the fifty-four percent is something (p. 50) which is utilized by accountants when they are in the area of estimation and planning.

I don't think it relates to usage when you are into actual figures—which we have available here from the returns.

Q Are your figures the actual returns themselves?

A I have used the actual returns or, as I have stated previously, the revenue agents report where it was—

THE COURT: How far apart are you.

THE WITNESS: We're approximately twenty-eight hundred dollars apart, I believe, on the tax question.

And the rest of the difference arises from the seventy-five hundred dollars which he is treating—well, I guess we're not—we're twenty-eight hundred dollars apart on the tax question—

MR. FLASKAMP: In other words—

A —overall.

THE COURT: Well, let me ask Mr. Essene a question there.

Mr. Essene, how do you justify taking fifty-four, when actually on the man's return—if you had to figure it out and pay it—it would be something substantially less than fifty-four percent?

MR. ESSENE: Well, we're using a federal rate of fifty, and the state rate of fifteen, each being cross deductible to the other. You have to do it by algebraic (p. 51) equation to get the correct amount.

THE COURT: I understand that.

But in the amount of tax that he was paying, aside from these computations, what was he actually paying in taxes? Isn't that more relevant than what would be the maximum?

MR. ESSENE: No, because what actually is paid is followed by consequences.

For example, if one year you got assessed an extra thousand dollars federal, then either that year or the next year, when you paid the thousand dollars, that would reduce your state tax by a hundred and fifty dollars. Then the following year, or that same year, on the federal—because your state tax had been reduced by one hundred fifty—there would be a seventy-five dollar additional federal tax. Which in turn would reduce the state by thirteen dollars. And down to zero. And it takes—

THE COURT: You know what that reminds me of—off the record.

(Remarks off the record).

THE COURT: All right, back on the record.

MR. FLASKAMP:

Q All right, now in connection with the seventy-five hundred dollars figure that was the basis of Mr. Essene's computation, do you agree with the manner in which he used that particular item as a capital investment?

(p. 52) A I really don't believe that is an accounting question.

It is my understanding the seventy-five hundred dollars was a loan.

As such, it would have been an addition to his basis for tax purposes.

And I find no objection to it being used in tax calculations.

But again that was fully considered by me, and I am sure by the Revenue Department, in their settlement in 1978, so we have both included the seventy-five hundred dollars in the tax calculation.

Whether it comes into the investment area, is not my prerogative.

I understand it was a loan someplace.

Q Well what I am getting down to is:

You had a difference in your calculations, from Mr. Essene's, in addition to the fifty-four percent in your numbers that you come up with here.

And where does that other difference come in sir?

A Well, we've several minor differences which I think should be made a matter of record, if you wish me to.

Q Go ahead?

A Could I have Mr. Essene's summary?

MR. BRUNIG: I believe it is in front of the (p. 53) witness as Exhibit A.

THE WITNESS: I don't have it.

MR. FLASKAMP:

Q Here, take this.

A Mr. Essene and I are in agreement I think as to the items which are Alotel items with the exception—if you go to our Exhibit A, as compared to the exhibit eight—Mr. Essene has included in 1975 legal and accounting expenses of seven hundred and eighty dollars.

I had no way of knowing at the time that I reviewed the returns that that was a pertinent Alotel item.

Apparently the taxpayer, Mr. Randall, in this case had incurred expenses relative to Alotel which he claimed on his return, but they were not Alotel items that were identified to me.

In 1977—excuse me—in both 1976 and 1977 there were items from the form 4797, as filed under the 1040, which were Alotel items which were not included, apparently in Mr. Essene's calculations. I do not know why they are not in there, but they are not.

The other differences are, of course, as I said before, that he used the fifty-four percent overall rate in each year, treating it somewhat differently in 1978 on recapture.

And our net difference for all of these years revolves about around twenty-eight hundred dollars difference in (p. 54) tax.

He has also shown on exhibit eight a total loss on investment, which differs from our presentation of the summary of damages sustained, by the amount of the seventy-five hundred dollars which he proposes to recapture here as a loss on investment.

And that's not my determination to make, whether that's part of the investment or not.

Q Elaborate on that. What do you mean by that? You have done what? Has he made some assumptions?

A Well, on his schedule on exhibit eight he shows, in the year 1975, cash invested of seventy-five hundred dollars.

I presume that those are the loans—in fact I think that was so testified.

In our summary we've not included the seventy-five hundred dollars as an investment.

THE COURT: And you were told not to do that by either Loftsgaarden or his lawyer?

THE WITNESS: Right, that is correct.

THE COURT: What?

THE WITNESS: That is correct, it's—

THE COURT: But you weren't satisfied that it was appropriate to treat as an investment for tax purposes?

THE WITNESS: Yes, the tax law is specific in that area, the loan would have been part of the taxpayer's basis.

(p. 55) I don't know that it would have been called "investment" per se. I don't know how definitive you want to get with the words here.

It's part of his basis.

THE COURT: So I would distinguish the Court of Appeals' finding that it couldn't be recovered, as part of a fraudulent transaction, from the total overall tax picture; and allow it to be used as Essene used it.

MR. FLASKAMP: We believe that it was a loan, and that what he receives back—the tax benefits—that's a recapture, per se.

THE COURT: Well your own witness says that it was appropriate to use it as a part of his investment basis.

Now which expert are you using to draw your conclusion?

MR. FLASKAMP: Gee, I didn't hear him say that.

MS. UNDERKUFFLER: Your Honor, I think maybe part of the problem is that it was used in two different places in Mr. Essene's report.

Maybe Mr. Carlson will correct me if I am wrong, but it is my understanding it was used as part of the basis.

And then at the end he subtracted it out as a—or he added it in as a loss on the investment.

I don't think we have any dispute that it would be—as far as an accounting principle—it would properly be (p. 56) included in the basis.

The problem we have is the fact that at the end he takes it as part of the loss on the investment.

Is that correct Mr. Carlson?

THE COURT: Well, that's consistent.

But you don't like the law as interjected by the Eighth Circiut, Laura. I think that's the problem. You are trying to cut it into two pieces—I think—now I want to be sure I am right.

MS. UNDERKUFFLER: Well, no, Your Honor, the problem is that they were denied recovery of the loans. That's the problem that they have on that matter.

And in fact this tax—back to this seventy-five hundred dollars—they are treating it is a tax benefit, and that in fact is what it was, as part of the basis for recapture.

THE COURT: Let's see if you and I can work this together so we have a kind of concise statement.

After the original partnership investment was made, over a period of two or three years, the plaintiff Randall loaned more money to the partnership.

MS. UNDERKUFFLER: Uh-huh (Nods head in an affirmative manner).

THE COURT: It is a non-recourse loan, but his equity in the partnership must have increased.

Anybody argue with that?

(p. 57) MR. FLASKAMP: Equity in the partnership?

THE COURT: Yes. He became a bigger partner than he was before.

MR. FLASKAMP: How could that be true if they all made loans?

THE COURT: Well, to the extent that his loan was bigger than anybody else's.

MR. FLASKAMP: Well, we don't know that.

THE COURT: No, but —

MR. FLASKAMP: Everybody made loans.

THE COURT: Okay. But I wonder if we couldn't resolve this now.

Did the fact that he made more loans — if he had made a bigger loan than someone else — would his partnership share have been bigger than the other persons?

MR. FLASKAMP: The witness says no.

THE COURT: How does the witness know? He doesn't have anymore evidence than you or I do.

MR. FLASKAMP: Well, we don't have any evidence either of what the other people loaned.

THE COURT: Wait a minute —

MR. GRIMSTAD: Your Honor, for the record it did not increase their limited partnership interest.

Their units stayed the same. Their interest in the partnership does not change, as a matter of partnership law.

(p. 58) What happens as a matter of tax law is that the basis in the limited partnership increased.

There is a different treatment for the legal ownership impact, and the tax impact.

MR. BRUNIG: I think we ought to maybe get some evidence on the subject, your Honor, from the witness;

rather than having lawyers speculate. I think that Mr. Grimstad's statement would be consistent with what the witness would testify to.

MR. FLASKAMP:

Q Do you agree with Mr. Grimstad there, Mr. Carlson?

A Yes.

I would only like to say in, from an accountant's point of view, as I understand it, Mr. Randall had two different hats at that time. He had one hat as a partner, and he had another hat as a creditor.

Now on your legal points of view, I would presume that you make a clean division between those two as to what he was, and apparently the courts have done that — I don't know what has transpired here.

But for income tax purposes, of computing his gains and losses, from the partnership, ultimately, the seventy-five hundred dollars would be considered part of his basis — as was explained.

It has nothing to do with the — we misquote, I (p. 59) guess, when we call it an "investment", I mean that gets kind of cluttered up.

THE COURT: Now Ms. Underkuffler has a different view of how it should have been handled in another place.

MS. UNDERKUFFLER: Maybe, Your Honor, the best thing would be to just ask the witness.

Q Mr. Essene's calculations came out seventy-five hundred dollars less in tax benefits than yours did — or

more, actually; but part of it was the seventy-five hundred dollar difference.

And could you tell us, Mr. Carlson, why you think that your treatment of the total tax benefit was preferrable to the method that was used by Mr. Essene, why did you use your method as opposed to his in the treatment of the seventy-five hundred?

A I want to make it clear that I don't believe Mr. Essene and I treated the seventy-five hundred dollars differently in the calculation of taxes.

We treated it differently in the summary of damages.

Again getting back to our Schedule C, we show an investment basis of $35,000.

Mr. Essene, in effect, in his summary has carried the investment at 42,500, including the $7,500 loan as part of the calculation.

(p. 60) It has nothing to do with the way we calculated the taxes.

The actual difference between Mr. Essene's tax calculations and mine are several minor items which he did not include, plus the thing that he did include of the attorneys' fees, which I mentioned, and the major item being the fact that he used an overall planning rate of fifty-four percent, whereas I went to the actual returns and used the government tables and the calculations as determined by the Internal Revenue Service and what would have been reportable according to those tables, with the actual numbers involved.

THE COURT: Okay.

Here is what I would like to have this witness do for me.

First of all if there are those attorneys' fees and expenses in connection with it, he doesn't have a basis to dispute that, so we allow it — the seven hundred bucks or whatever it was.

MR. FLASKAMP:

Q We'd agree with that, wouldn't we?

A You understand that is only a number which you utilize to arrive at a tax calculation.

It is not part of the damages.

Q Oh, well I guess —

A In other words, if you are going to use Mr. (p. 61) Essene's approach, you would use the fifty-four percent, I presume, of the $700.

Q Oh, fifty-four percent of seven hundred on the Essene approach?

A Yes.

MR. FLASKAMP: Well, we would agree that fifty-four percent of the seven hundred dollars could be included in the damages.

THE COURT: Okay.

Now next I would feel better about taking the actual tax rate. And I don't think that will change it much, maybe two thousand bucks or less, right?

THE WITNESS: As I said, our differences according to the tax calculations are twenty-eight hundred dollars.

THE COURT: All right, do the $2,800.

Then I am going to give you my rationale for allowing them to use the $7,000 as —

MR. FLASKAMP: 7500.

THE COURT: — or 7500 as part of the loss; and that is that we don't want to confuse what the Court of Appeals said in the two different sides of its statement.

It said the seventy-five hundred is not recoverable.

But it did not say that the seventy-five hundred could not be used to compute the actual loss.

(p. 62) MR. FLASKAMP: Well, he doesn't know anything about that. He's never read that appellate decision.

THE COURT: Yes, but I know about it —

MR. FLASKAMP: Yes.

THE COURT: — and so that we have it on the record here, and this is the way my opinion would appear, that it would be highly inequitable for the Court of Appeals to say, "No, you can't recover it; and, furthermore, since you can't recover it, you can't even count it as part of your tax loss."

I say that, even though they couldn't recover it, they can show it in the actual transaction as to what their actual loss was or what their advantage was from the tax returns, however you want to put it.

MR. FLASKAMP: So you have just saved two paragraphs in your memorandum.

THE COURT: The law clerk will take care of that. That's why I say it sometimes. Okay?

MR. FLASKAMP: Okay.

I am going to offer that Exhibit 3(sic), your Honor.

THE COURT: All right.

MR. FLASKAMP: Exhibit 1-C.

THE COURT: All right.

Now, Mr. Essene, you two can maybe sit down and agree on it, what the actual tax — take the rate that actually (p. 63) appears in the returns, so we just get rid of it; it doesn't make a whole lot of difference anyway.

MR. GRIMSTAD: Now, your Honor, if I may:

Based upon what you have just idicated about separating the Court of Appeals opinion — from the recovery on one side, to the calculation of loss on the other — that could conceivably change our position concerning the tax calculations; because we followed the method that they were following.

THE COURT: Did you hear that?

MR. FLASKAMP: No I didn't hear that.

MR. GRIMSTAD: We followed the method that the defendants were following.

THE COURT: Now that I have ruled in favor of Randall in terms of how he handled the loan, the other plaintiffs want to recompute theirs.

MR. GRIMSTAD: Other than that, we would not have any differences between the defendant and my plain-

tiffs — but not in the calculation of the other tax benefits.

THE COURT: Is Essene doing your accounting, too?

MR. GRIMSTAD: No, he's not, your Honor.

THE COURT: Well, you better get your accountants together with Mr. Carlson and see how that works out.

MR. GRIMSTAD: One of our attorneys has met with Mr. Carlson and gone over some of his calculations, and we can do that again.

(p. 64) THE COURT: Okay. Anything else?

MR. FLASKAMP: Yes, we do, Laura has one question she would like to put —

THE COURT: Go ahead.

MR. FLASKAMP: — but, before you do that:

So that we get the scope of this, they are going to get together now, and they want to say, "We're going to treat this now as an investment of capital for tax purposes, even though you can't recover for the loan, and figure out the difference then in those two numbers"?

THE COURT: Right.

MR. FLASKAMP: So you want to have that as an alternative number some place?

THE COURT: Right.

MR. FLASKAMP: Uh-huh. Well we can do that.

THE COURT: Okay.

MR. FLASKAMP: All right, go ahead.

MS. UNDERKUFFLER:

Q Mr. Carlson, you were here when Mr. Essene testified in response to the Court's questioning that, if Randall had gotten away without reporting his recapture, in 1981, as a result of the audit, that Mr. Loftsgaarden would have been better off.

Do you have any response to that particular position?

(p. 65) A I don't know if I have a response which is definitive.

It certainly raises questions in my mind — I don't remember the basis on which he did not report that in 1978, or was advised not to report it.

I guess I would respond with a question that, if he did not report it in 1978 based on that advice, would he have later on reported it in some other year and, at that point, had the same or approximately the same tax consequence from the recapture?

I mean you can't — you don't just — sometimes things slide through the cracks with the Internal Revenue Service.

But I think if they had accepted his approach as to why it wasn't reported in 1978, would he then have years which are open— since then — which the Internal Revenue Service could then say, "Yes, now you must recapture it because we accept your original argument?"

THE COURT: But at least if he took any unconscionable step, as Mr. Flaskamp kind of indicated at an earlier time, that unconscionable step — absent having had to have paid it in a later year, it would have inured to the benefit of Loftsgaarden, wouldn't it; his failure to report the recoupment?

THE WITNESS: If he had never reported, Your Honor, (p. 66) that would be true.

THE COURT: Yes, okay.

MS. UNDERKUFFLER:

Q And that would also have been true if he had never reported any of his various items, isn't that the case?

A Well, anything on the return, he could leave out his salary —

THE COURT: But at least Loftsgaarden is not in a position to say that Randall was trying to cheat him by doing anything.

It was between him and the government, it was between Randall and the government at that point.

MS. UNDERKUFFLER: Your Honor, we have never made any allegation that doctor Randall's actions were dictated by trying to cheat Mr. Loftsgaarden.

He was trying to avoid paying taxes.

THE COURT: But I want the record to show my finding in that respect.

MS. UNDERKUFFLER: Your Honor, I don't think we have any further questions of this witness.

For the record I would like to make a few comments with regard to the issues on which the court has indicated it will rule against us.

With regard to the attorneys fees issue, it is our position —

(p. 67) THE COURT: Just a minute, somebody is standing up over there.

MS. UNDERKUFFLER: Oh, yes —

MR. BRUNIG: Yes, I think we should have our opportunity to cross examine the witness before counsel makes her argument.

MS. UNDERKUFFLER: You certainly have, go right ahead.

THE COURT: Okay.

And then the other thing is, basically, I don't think we've added a whole lot to the briefs here, and that was the basis on which I made my ruling when we came in, to save you a lot of trouble.

Go ahead.

CROSS EXAMINATION

MR. BRUNIG:

Q Mr. Carlson, you testified that you weren't aware of where Doctor Randall got the seven hundred eighty dollars on his tax return, that it wasn't indicated as such, did you not?

A Yes, I was not aware of it when I made my calculations, that there were any other Alotel items in that tax return.

Q Would you turn your attention to schedules E and R on Exhibit Three, Doctor Randall's 1975 tax return?

A Which schedule?

(p. 68) THE COURT: E and R

MR. BRUNIG:

Q Schedule E and R on —

MS. UNDERKUFFLER: We have our copies.

I don't know where the clerks' exhibits are.

THE COURT: Give him your copy.

MR. BRUNIG: All right — I am afraid my client took the exhibits, or my clients' account and took the exhibits.

Exhibit 3, the seventy-five returns, schedules E and R?

A Okay, yes.

Q Would you look at part three, Alotel Associates, unreimbursed expenses, there is a seven hundred eighty dollars expense item there, isn't it?

A Yes, there is.

Q And that appears to be the same item, does it not?

A That is true.

Q And in fact down—.

The explanation of column E, part two, it has the expenses for that, does it not?

A It does.

Q And it lists accounting fees, legal fees, et cetera?

A That is right (Nods head in an affirmative manner).

(p. 69) Q Now you don't claim to be an expert on the law as it applies to this case, do you Mr. Carlson?

A No.

Q So the question of damages is not a part of your opinion.

It is only the tax consequences that you have a professional opinion concerning.

Is that correct?

A That is correct.

Q You testified that there was a reduction in the capital investment as a result of Doctor Randall and the others investments in Alotel Associates, did you not?

A I believe that I testified that that is the way that an investor would, that I am acquainted with, would evaluate the situation, yes (Nods head in an affirmative manner).

Q And a reduction in capital investment is not income for tax purposes, is it?

A No.

Q And so to say that the amounts, which were deducted as losses from the investment, then constituted a reduction in the capital investment wouldn't have been income received by Doctor Randall or the others, would it.

THE COURT: Are you worried that I was mixed up about that?

(p. 70) MR. BRUNIG: Well I just wanted the witness's opinion as to whether or not the tax consequences

of Doctor Randall's investment in Alotel Associates constituted income which Doctor Randall received.

THE COURT: The answer is no.

MR. BRUNIG: Is that your opinion?

THE COURT: I take judicial notice that he didn't receive any income.

MR. BRUNIG: Well I just wanted to know if that was the witness's opinion.

THE WITNESS: The seventy-five hundred dollars was income?

THE COURT: No.

MR. BRUNIG: No.

THE WITNESS: Excuse me.

I guess I don't understand the question.

THE COURT: You took about twenty-six hundred dollars off his investment there.

And you said that is a reduction in capital investment over a period of a couple years.

And is that income?

MR. BRUNIG:

Q Is that income?

A I still do not understand the question.

I'm very sorry, but I just don't.

(p. 71) Q Okay. Is the reduction in capital investment which Doctor Randall incurred by virtue of his in-

vestment in Alotel Associates, and the tax consequences in that investment, income which Doctor Randall received?

A I would not consider it as such (shakes head in a negative manner).

MR. BRUNIG: I don't believe I have any further questions, your Honor.

* * *

DEFENDANTS' NO. 1-A

TABLE I.

The following items are the actual deductions or credits (or if, in parentheses, the amounts of recapture) taken by the plaintiffs on their tax returns, as a result of their investment in Alotel Associates, for the years 1973-1978:

Randall	1973	1974	1975	1976	1977	1978
Schedule D						($30,075)
Schedule E	$21,119	$30,107	$23,023	$17,700	$14,716	(1,963)
4797				70	627	
Inv. credit		2,451	75	52		
Ch. recapture				36	1,323	79
Austin						
Schedule D						(27,692)
Schedule E	21,120	30,028	22,177	17,301	14,636	(1,963)
4797					693	
Inv. credit		2,451	75	52		
Cr. recapture				69	1,323	79
Anderson						
Schedule D						(30,076)
Schedule E	21,120	30,048	22,177	17,301	14,636	(1,963)
4797					706	
Inv. credit		2,451	75	52		
Cr. recapture				48	1,323	79
Neumann						
Schedule B			130			
Schedule D						(60,552)
Schedule E	31,679	45,030	33,265	25,951	21,955	(12,767)
4797				105	942	
Inv. credit		3,677	113	77		
Cr. recapture						

Note: These deductions and credits were obtained by the plaintiffs for an investment of $35,000 each, with the exception of Neumann, who invested $52,500.00.

DEFENDANTS' NO. 1-B

TABLE II.

The following items are the amount of net reduction in Federal and State income taxes which the plaintiffs obtained as a result of the deductions and credits shown on Table I, for each year from 1973-1978, together with total permanent tax benefits after recapture:

	Net Reduction In Federal Income Taxes			
	Randall Anderson		Austin Neumann	
1973	$ 1,333	$ 8,053	$ 9,903	$14,813
1974	16,584	13,482	15,882	6,279
* 1974 I.C.C.B.				3,677
1975	9,507	10,125	9,917	10,962
1976	9,033	9,942	2,211	3,062
* 1976 I.C.C.B.				77
1977	6,543	7,354	5,871	6,294
1978	(16,014)	(28,031)	(19,459)	(4,537)
	$26,986	$20,925	$24,325	$40,627
** 1978 T.C.B.O.	$2,160	$3,927	$2,726	$ 559

Net Reduction In
Minnesota Income Taxes

	Randall Anderson		Austin Neumann	
1973	$3,166	$3,168	$3,163	$4,747
1974	4,684	3,667	3,377	3,569
1975	974	862	946	3,469
1976	1,239	1,069	1,113	1,826
1977	754	618	1,775	2,706
1978	(5,841)	(7,943)	(6,815)	(699)
	$4,976	$1,441	$3,559	$15,618
** 1978 T.B.C.O.	$2,282	$3,322	$2,723	$ 210

PERMANENT TAX REDUCTION
AFTER RECAPTURE (1978)

	Randall Anderson		Austin Neumann	
	$26,986	$20,925	$24,325	$40,627
Federal	2,160	3,927	2,726	559
	4,976	1,441	3,559	15,618
State	2,282	3,322	2,723	210
	$36,404	29,615	33,333	57,014

* I.C.C.B. Investment Credit Carry Back

** T.B.C.O. Tax Benefit Carryover of Cross Deduction

DEFENDANTS' NO. 1-C

TABLE III.

SUMMARY OF DAMAGES SUSTAINED BY PLAINTIFFS AFTER RECAPTURE:

Company Permanent Tax Reduction After Recapture (Table II) with amount invested, the plaintiffs show the following total damages* sustained:

Austin	$27,884	
	5,449	
	$33,333	— tax benefits
Investment total:	$35,000	
Total damages:	1,667	
Anderson:	$27,884	
	7,249	
	$29,615	— tax benefits
Investment total:	$35,000	
Total damages:	5,385	
Neumann:	$56,245	
	769	
	$57,014	— tax benefits
Investment total:	$52,500	
Total damages:	Zero	
Randall:	$31,962	
	4,442	
	$36,404	— tax benefits
Investment total:	$35,000	
Total damages:	Zero	

*This does not include the use of the much larger amount of money which the plaintiffs had as the result of the net reduction in state and federal income taxes during the years 1973-1977, prior to recapture. *See* Table II.

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA
FOURTH DIVISION

AFFIDAVIT OF
JOHN ESSENE

Filed January 25, 1984

(Title Omitted in Printing)

STATE OF MINNESOTA)
) ss.
COUNTY OF HENNEPIN)

JOHN ESSENE, being first duly sworn, upon oath deposes and states:

1. I am a certified public accountant and am authorized to practice my profession in the State of Minnesota.

2. At all relevant times, I have provided accounting services to and prepared federal and Minnesota state income tax returns for William C. Randall.

3. I have reviewed a letter dated January 4, 1984, and addressed to Meagher, Geer, Markham, Anderson, Adamson, Flaskamp & Brennan by John M. Carlson. It is my opinion that Mr. Carlson's statement:

> I have calculated the 1978 tax benefit arising from the $7,500 recognition and basis, and it reduced the federal and Minnesota tax for that year in the amounts of $1,875 and $636 respectively.

requires clarification. Dr. Randall made two loans to Alotel Associates; he did do in 1975. The total amount of the two loans was $7,500.00. Dr. Randall's federal and Minnesota state income tax returns treated the $7,500.00 in loans as an increase in the "basis" of his investment in Alotel Associates. The "basis" was increased as of the

dates of the loans, not as of 1978. Both the Internal Revenue Service and the Minnesota Department of Revenue have accepted that treatment. Both the Internal Revenue Service and the Minnesota Department of Revenue audited Dr. Randall's 1978 income tax returns. Both the Internal Revenue Service and the Minnesota Department of Revenue determined that Alotel Associates should have treated the foreclosure of the Ramada Inn in Rochester, Minnesota, which Alotel Associates had owned, as a "disposition" of the property, that Dr. Randall should have recognized his *pro rata* portion of the "gain" and should have "recaptured" certain accelerated depreciation and portions of investment tax credits and that Dr. Randall owed additional taxes. If Dr. Randall had not increased the basis of his investment in Alotel Associates by $7,500.00 in 1975 by virtue of his loans to Alotel Associates he would have had a lesser "basis" in his investment in Alotel Associates, would have been required to recognize greater "gain" in 1978 and would have been required to pay additional federal and Minnesota income taxes in 1978. Because the increase in his "basis" in Alotel Associates resulted in a lesser "long-term capital gain," the combined federal and Minnesota "tax benefit" was approximately $2,025.00. If Dr. Randall, the Internal Revenue Service and the Minnesota Department of Revenue had disregarded the loans, Dr. Randall's "damages" would have been greater (if it were to be assumed that "tax benefits" reduce damages); if Dr. Randall, the Internal Revenue Service and the Minnesota Department of Revenue had not treated the loans as an increase in the basis of Dr. Randall's investment in Alotel Associates and had treated the loans as ordinary loans, Dr. Randall would have been entitled to a "bad debt" deduction. Because a "bad debt" deduction would have reduced Dr.

Randall's adjusted gross income and because such income is taxed at a rate higher than the rate at which "long-term capital gains" are taxed, such treatment would have offered Dr. Randall a greater "tax benefit." However, neither Dr. Randall, the Internal Revenue Service nor the Minnesota Department of Revenue considered such treatment appropriate. In addition, Dr. Randall disbursed $780.00 in legal and accounting fees in 1975 and did deduct those fees on his 1975 federal and Minnesota state income tax returns. Those fees did not affect Dr. Randall's "basis" in Alotel Associates. However, the "tax benefit" which Dr. Randall realized from his payment of those fees was only approximately $421.00. Thus, he had an actual out-of-pocket expenditure of $359.00. He has never been reimbursed for that expenditure and has not obtained any further "tax benefit."

4. I have reviewed a letter dated January 5, 1984 and addressed to Roberta Walburn by Laura S. Underkuffler. The calculations and conclusions expressed in that letter do not appear to be based upon any general accepted accounting principle. In fact, Dr. Randall, the Internal Revenue Service and the Minnesota Department of Revenue all considered Dr. Randall's original "basis" in Alotel Associates to be the $35,000.00 which he invested in 1973; all increased his basis by the $7,500.00 in loans which he made to Alotel Associates in 1975; and all now consider him to have disposed of his investment in Alotel Associates in 1978. Ms. Underkuffler's letter seeks to increase Dr. Randall's "basis" by $2,512 in 1975 and to take advantage of a "tax benefit" of $2,512.00 in 1978. That ignores the uniform treatment of the loans by Dr. Randall, by the Internal Revenue Service and by the Minnesota

Department of Revenue. Although the $780.00 which Dr. Randall deducted as a legal and accounting fee attributable to Alotel Associates in 1975 "does not affect [Dr.] Randall's basis," it does relate to an expenditure made and a loss suffered by Dr. Randall. If Dr. Randall had not invested in Alotel Associates, he would not have expended monies for those fees. Although Dr. Randall was able to deduct those fees as a "business expense," he has never been reimbursed for the approximately $359.00 which he has not recovered either in cash or from the "tax benefit" of his allowable deduction.

5. It is my opinion that any recovery which Dr. Randall may obtain and which constitutes a "disposition" of his investment in Alotel Associates or interest will be subject to both federal and Minnesota state income taxes. Because the combined marginal rate on Dr. Randall's ordinary income, including interest, would be approximately 54% and upon "long-term capital gain" would be approximately 22%, it is my opinion that in order to make Dr. Randall "whole" ordinary income, including interest, should be multiplied by 2.173 and that return of his investment should be multiplied by 1.282.

FURTHER AFFIANT SAITH NOT.

/s/ John Essene

Subscribed and sworn to before me
this 24th day of January, 1984.

/s/ Tammy J. Heuer
Notary Public

(SEAL) TAMMY J. HEUER
NOTARY PUBLIC—MINNESOTA
HENNEPIN COUNTY
My Commission Expires Aug. 25, 1990

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA
FOURTH DIVISION

AFFIDAVIT OF JOHN M. CARLSON

Filed February 13, 1984

[Title Omitted in Printing]

STATE OF MINNESOTA)
) ss.
COUNTY OF HENNEPIN)

JOHN M. CARLSON, being duly sworn on oath, deposes and states:

1. That he is a Certified Public Accountant, as previously indicated to the Court in his testimony at the above-entitled matter;

2. That at the request of the defendants in the above matter, he has made certain simple arithmatic calculations as to the amount of interest to which each of the plaintiffs would be entitled, taking into account the tax benefits received by each plaintiff during each year of his investment in Alotel Associates. It is your affiant's understanding that these calculations have been previously supplied to the Court with the defendants' post-trial memorandum. They are attached hereto as Exhibit "A";

3. That at the request of the Court in the above-entitled matter, he has made certain calculations as to the income tax benefit which resulted from the inclusion of the $7,500.00 in loans and plaintiff Randall's basis when he

experienced recapture in 1978. Those calculations are attached hereto as Exhibit "B".

Further your affiant sayeth not.

/s/ John M. Carlson

Subscribed and sworn to before me
this 13 day of February, 1984.

/s/ Sandra K. Smith

SANDRA K. SMITH
Notary Public—Minnesota
(SEAL) Ramsey County

My Commission Expires
March 18, 1989

EXHIBIT A

RANDALL

	Invested	Net Reduction (increase) In Tax Liability Current	Carry-back	Balance	Days	Interest Cost (earned) at 8%/ annum
11/13/73	35,000			35,000	153	1,174
4/15/74		4,449		30,501	365	2,440
4/15/76		10,481		(1,248)	365	(100)
4/15/75		21,268		9,233	365	739
4/15/77		10,272		(11,520)	365	(922)
4/15/78		7,297		(18,817)	365	(1,505)
4/15/79		(21,855)		3,038	365	243
4/15/80		4,442		(1,404)	1,339	(412)
12/15/83	35,000	36,404		(1,404)	3,682	1,657

ANDERSON

6/ 2/73	35,000			35,000	317	2,432
4/15/74		11,221		23,779	365	1,902
4/15/75		17,149		6,630	365	530
4/15/76		10,987		(4,357)	365	(349)
4/15/77		11,011		(15,368)	365	(1,229)
4/15/78		7,972		(23,340)	365	(1,867)
4/15/79		(35,974)		12,634	365	1,011
4/15/80		7,249		5,385	1,339	1,580
12/15/83	35,000	29,615		5,385	3,846	4,010

NEUMANN

8/21/73	35,000			35,000	58	445
10/19/73	17,500			52,500	178	2,048
4/15/74		19,500		32,940	365	2,635
4/15/75		9,848		23,092	365	1,847
7/15/75			3,677	19,415	91	387
4/15/76		14,431		4,984	274	299
4/15/77		4,888		96	365	8
7/15/77			77	19	91	..
4/15/78		9,000		(8,981)	274	(539)
4/15/79		(5,236)		(3,745)	365	(299)
4/15/80		769		(4,514)	1,339	(1,325)
12/15/83	52,500	53,260	3,754	(4,514)	3,765	5,506

Note: On carrybacks (Neumann) July 15 was used assuming carrybacks were filed concurrently with tax returns and that Form 1139 was used—IRS has 90 days to make refund or take action.

AUSTIN

		Net Reduction (increase) In Tax Liability				Interest Cost (earned) at 8%/
	Invested	Current	Carry-back	Balance	Days	annum
6/26/73	35,000			35,000	293	2,248
4/15/74		13,066		21,934	365	1,755
4/15/75		19,259		2,675	365	214
4/15/76		10,863		(8,188)	365	(655)
4/15/77		3,324		(11,512)	365	(921)
4/15/78		7,646		(19,158)	365	(1,533)
4/15/79		(26,274)		7,116	365	569
4/15/80		5,449		1,667	1,339	489
12/15/83	35,000	33,333		1,667	3,822	2,166

SUMMARY

	Invested	Tax Benefit	Interest Cost	Damages and Interest
RANDALL	35,000	36,404	1,657	253
ANDERSON	35,000	29,615	4,010	9,395
NEUMAN	52,500	57,014	5,506	992
AUSTIN	35,000	33,333	2,166	3,833

No recognition is given in these figures to $780 legal cost claimed by Randall in 1975 as this was not a flow-through item from partnership. If he is to be credited at 46% then his damages would increase $359 and interest thereon from 4/15/76 would be $220—Total Additional $579.

EXHIBIT B

JOHN M. CARLSON, C.P.A. 612 484-0602
SUITE 219 3570 LEXINGTON PKY. NO.
SAINT PAUL, MINNESOTA 55112

MEMBER:
AMERICAN INSTITUTE AND
MINNESOTA SOCIETY OF
CERTIFIED PUBLIC ACCOUNTANTS

January 4, 1984

Meagher, Geer, Markham, Anderson
Adamson, Flaskamp and Brennan
2250 IDS Center
Minneapolis, Minnesota 55402

Dear Ms. Underkuffler,

It appears from the returns filed and from the revenue agent's report that William Randall was given a basis credit of $7,500 for his loans to Alotel.

The basis only affects tax calculations in 1978, which is the year of recapture. I have calculated the 1978 tax benefit arising from the $7,500 recognition in basis, and it reduced the federal and Minnesota tax for that year in the amounts of $1,875 and $637 respectively.

The $780 legal and accounting expense claimed by Dr. Randall in 1975 did not affect his basis since it was disbursed and deducted in the same year. As previously discussed, this item was not a pass through item in the partnership accounting.

Very truly yours,
/s/ John M. Carlson

JMC:rc

BEST AVAILABLE COPY

Supreme Court, U.S.
FILED
JAN 6 1986
JOSEPH F. SPANIOL, JR.
CLERK

No. 85-519

In The

Supreme Court of the United States

October Term, 1985

DR. WILLIAM C. RANDALL,
DR. ROGER E. AUSTIN,
DR. TOM W. ANDERSON and
DR. MYREL A. NEUMANN,

Petitioners,

v.

B. J. LOFTSGAARDEN; ALOTEL INCORPORATED, a Minnesota corporation; PROPERTY DEVELOPMENT AND RESEARCH COMPANY, a Minnesota corporation; and 2361 BUILDING CORPORATION, a Minnesota corporation,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE PETITIONERS

* Robert Arthur Brunig
O'CONNOR & HANNAN
3800 IDS Tower
80 South Eighth Street
Minneapolis, Minnesota 55402
Telephone: (612) 343-1200

Ted S. Meikle
FREDRIKSON & BYRON, P.A.
1100 International Centre
900 Second Avenue South
Minneapolis, Minnesota 55402
Telephone: (612) 347-7000

Terence M. Fruth
FRUTH & ANTHONY, P.A.
1350 International Centre
900 Second Avenue South
Minneapolis, Minnesota 55402
Telephone: (612) 349-6969

Wilbur F. Dorn, Jr.
DORN LAW FIRM, LTD.
300 East Main Street
Anoka, Minnesota 55303
Telephone: (612) 427-5903

Counsel for Petitioners

* Counsel of Record

COCKLE LAW BRIEF PRINTING CO., (800) 835-7427 Ext. 333

QUESTIONS PRESENTED

1. Whether favorable tax consequences to defrauded investors in a limited partnership, together with imputed interest thereon, constitute "income received" which section 12(2) of the Securities Act of 1933 requires be deducted from the consideration paid when the investors' purchase of the securities is rescinded.

2. Whether favorable tax consequences to defrauded investors in a limited partnership, together with imputed interest thereon, are to offset rescissionary damages awarded pursuant to section 10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission Rule 10b-5 to insure that the investors do not recover more than "actual damages."

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OPINIONS BELOW

The *en banc* opinion ot the Eighth Circuit and the accompanying panel opinion (hereinafter "*Austin II*") are reported at 768 F.2d 949 and are set forth in Petition Appendix A. The unreported Amended Judgment and the unreported Order of the district court on a remand by the Eighth Circuit on a prior occasion are set forth in Petition Appendices B and C. The earlier opinion of another panel of the Eighth Circuit (hereinafter "*Austin I*") is reported at 675 F.2d 168 and is set forth in Petition Appendix D. The unreported Findings of Fact, Conclusions of Law and Order for Judgment and the Memorandum Order of the district court at the conclusion of the first trial are set forth in Petition Appendices E and F.

JURISDICTIONAL STATEMENT

The judgment of the Court of Appeals for the Eighth Circuit was entered on July 16, 1985. The Petition for a Writ of Certiorari was filed on September 24, 1985, and was granted on November 12, 1985. (J.A.3). This Court's jurisdiction is invoked pursuant to 28 U.S.C. § 1254(1).

STATUTES AND REGULATION

Section 12(2) of the Securities Act of 1933, 15 U.S.C. § 77*l*(2):

> Any person who—
>
> * * *
>
> (2) offers or sells a security . . . by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral com-

> munication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,
>
> shall be liable to the person purchasing such security from him who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b):

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national security exchange—
>
> * * *
>
> (b) To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. § 240.10b-5:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national security exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,

> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Section 28(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78bb(a):

> The rights and remedies provided by [the Securities Exchange Act of 1934] shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of [the Securities Exchange Act of 1934] shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of the actual damages on account of the act complained of.

STATEMENT OF THE CASE

Petitioners are four investors who purchased one or more units[1] in Alotel Associates, a limited partnership formed to operate a Ramada Inn in Rochester, Minnesota. (Pet.App.D1). Respondents are the individual and corporate general partners of Alotel Associates and their affiliates. (Pet.App.D3-D4).

Respondents distributed an Offering Memorandum to potential investors, including Petitioners. (Pet.App. D7). The Offering Memorandum purported to describe the limited partnership, the Ramada Inn project, the terms available for financing the partnership's activities and the timetable for constructing the Ramada Inn. (Pet.App.D7;

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[1] The price of each unit was $35,000. (Pet.App.D7).

Pl.Ex.2; Tr.42). The Offering Memorandum contained a *pro forma* projection of cash flow, of resale price and anticipated profit at the time of resale and of the tax consequences of a limited partner's investment. (Pl.Ex.2 at 27; Tr.42).

The Offering Memorandum misrepresented the rate and amount of interest to be paid for construction financing, the length of a ground lease, the completion date and the terms of financing available for furnishings and equipment. (Pet.App.D7-D8). The Offering Memorandum described a non-existent commitment for long-term financing. (Pet.App.D8). The Offering Memorandum omitted information about the control which Respondent B. J. Loftsgaarden (hereinafter "Loftsgaarden") exercised over Respondents Alotel Incorporated, Property Development and Research Company (hereinafter "PDRC") and 2361 Building Corporation (hereinafter "2361"), about PDRC's anticipated profits on a sale of land, about a commitment fee to be paid to PDRC, about Loftsgaarden's interest in arc-TECH, inc., a firm which was to design the Ramada Inn and to supervise its construction and about Loftsgaarden, PDRC, 2361 and arc-TECH, inc.'s anticipated profits. (Pet.App.D9, E11).

PDRC received $23,100 as a commitment fee and $57,390 for undisclosed purposes. (Pet.App.E11; Pl.Ex 50; Def.Ex.41A; Tr.371,662). PDRC also earned a profit of between $37,388 and $54,078 on land transactions. (Pet. App.D9,E7; Pl.Ex.51,55,56; Tr.372,398,403-07). 2361 received $35,000 as "contractor's overhead," $23,524 for "reimbursement," $449 for "general contracting services," $3,972 for "contracting work" and $2,349, $63,724 and

$38,041 for undisclosed purposes.[2] (Def.Ex.41B,41C,41E, 41F,41G,41H,41J,41K; Tr.662). Arc-TECH, inc., received $90,000 for its services. (Pet.App.E7,E11).

The limited partners' investments and the available loans proved insufficient to construct and furnish the Ramada Inn. (Pet.App.D10). Alotel Associates had no initial operating capital. Alotel Associates was forced to obtain additional investors. (Pet.App.D10; Pl.Ex.79; Tr. 672-73,693-94). The additional investments proved insufficient, and the business continued to flounder. The investors then made several loans to Alotel Associates.[3] (Pet.App.F12). Alotel Associates ultimately defaulted on its loans and its rental payments, and its creditors foreclosed. (Pet.App.D10; Pl.Ex.46; Tr.348,350,577).

On February 24, 1976, Petitioners and others commenced this action to recover their investments. (J.A.1; D.R.1-10). Their amended complaints alleged that Respondents had violated sections 12(2) and 17(a)[4] of the Securities Act of 1933, 15 U.S.C. §§ 77*l*(2) and 77q(a); section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b); Rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. § 240.10b-5; and section 1 of the Minnesota Uniform Securities Act, Minn. Stat. § 80A.01 (1978), had committed a fraud under the common law of Minnesota, had been negligent and had breached fiduciary duties to Petitioners.[5] (D.R.219-46,266-74). Petitioners alleged misrepresentations and omissions of material in-

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2 Respondents had anticipated that 2361 would receive $316,572 as "overhead" and "contingency and profit." (Pet. App.E5; Pl.Ex.27 at 2; Tr.305).

3 The total loans "assessed" against each unit was $8,500. (Pl.Ex.34-45; Tr.337,345,497).

4 The district court dismissed Petitioners' section 17(a) claim.

5 Petitioners discontinued their negligence and breach of fiduciary duty claims at trial. (Tr.730).

formation. (DR.219-46,266-74). They sought rescission[6] or damages. (D.R.245-46,273-74).

Respondents denied liability. (D.R.196-218). Respondents argued that reductions in Petitioners' federal and state income tax liabilities which resulted from deductions Petitioners took as a result of operating losses sustained by and depreciation and investment credits attributable to Alotel Associates constituted "income received" and that section 12(2) mandated that "income received" be deducted from any recovery. (Pet.App.F5-F9). They also argued that the tax consequences reduced the "actual damages" to which Petitioners might be entitled under section 10(b) and Rule 10b-5. (Pet.App.F5-F9).

The district court refused Respondents' request to instruct the jury that it might reduce damages by "income tax benefits which [Petitioners had] obtained." (D.R.365; Tr.740-42). Instead, the district court found that "the limited partnership units in Alotel Associates . . . were valueless" at the time Petitioners discovered the fraud. (Pet.App.E13). The district court therefore instructed the jury that Petitioners' damages under section 10(b), Rule 10b-5, Minn. Stat. § 80A.23 and common law fraud would "be equal to the amounts of monies which [Petitioners had] paid out in reliance upon the false representations." (Tr.805). The district court concluded that Petitioners were "entitled to recover the consideration [they had] paid for the limited partnership units" under section 12(2) and held that the "out-of-pocket [and] rescissionary measures [of damages] would yield the same results." (Pet.App.F7). Based upon the jury's verdict and its own findings, the district court awarded Petitioners judgment

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[6] Petitioners had tendered their limited partnership units to Respondents. (Pet.App.D18,E14; Ct.Ex.2,3; Tr.626,629).

in amounts equal to the amounts of their investments plus interest[7] on the amounts of their investments.[8] (Pet.App. E16,F15-F16).

Respondents appealed. (J.A.2). An Eighth Circuit panel affirmed the jury's and the district court's findings of liability, but vacated and remanded to the district court for a new trial on the issue of damages. The panel held that

> in a private securities fraud action involving an investment structured and marketed as a tax shelter, where a rescissory measure of damages is applied, evidence of any benefit derived by the plaintiff/investor via tax savings must be permitted.

Austin I at 183-84. The panel aslo held that "the damage award must be reduced by any value shown to have been received by plaintiffs." *Austin I* at 181.

On remand, the district court stated:

> [T]he starting point for assessing damages will be the amount each plaintiff paid Loftsgaarden for his investment (in other words, the plaintiff's consideration). To this, the court will add 8 percent interest from the date the consideration was paid to the date of this order. Finally, the amount of each plaintiff's tax benefits will be subtracted from the sum of his consideration and interest.

(Pet.App.C5). The district court then made the following calculations and awards:

Plaintiff Anderson	
Consideration paid June 2, 1983:	$35,000.00
Plus interest at 8 percent to February 22, 1984:	$64,787.00
Minus tax benefits:	$29,615.00
Total Damages:	$35,172.00

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7 Interest was awarded pursuant to the statutory mandates in section 12(2) and in Minn. Stat. § 80A.23, subd 2.

8 The district court denied Petitioners a return of their "loans" to Alotel Associates. (Pet.App.A3,D10,E12,F12-F13).

Plaintiff Austin	
Consideration paid June 6, 1983:	$35,000.00
Plus interest at 8 per cent to February 22, 1984:	$64,610.00
Minus tax benefits:	$33,333.00
Total Damages:	$31,277.00
Plaintiff Ne[u]mann	
Consideration paid August 21, 1973:	$35,000.00
Plus consideration paid October 19, 1973:	$17,500.00
Plus interest at 8 percent to February 2, 1984:	$96,385.00
Minus tax benefits:	$57,014.00
Total Damages:	$39,371.00
Plaintiff Randall	
Consideration paid November 13, 1973:	$35,000.00
Plus interest at 8 percent to February 22, 1984:	$63,770.00
Plus consideration paid 1975:	$ 2,512.00
Plus interest at 8 percent to February 22, 1984:	$ 4,203.00
Subtotal:	$67,973.00
Minus tax benefits:	$36,404.00
Total Damages:	$31,569.00

(Pet.App.B1-B2).

Respondents again appealed. (J.A.3). The Eighth Circuit *sua sponte* granted *en banc* consideration as to whether *Austin I* should be reconsidered and as to whether damages had been calculated properly if *Austin I* had been decided properly. *Austin II* at 951. The Eighth Circuit then held that *Austin I* had been decided correctly. To compute the recovery the Eighth Circuit adopted a formula: add interest to the consideration paid for the security, subtract "tax benefits" received and imputed interest thereon, then multiply the difference by two. The Eighth Circuit therefore reduced the awards as follows:

Austin ($7,666), Anderson ($18,790), Neumann ($1,984) and Randall ($506). *Austin I* at 961.

On September 24, 1985, Petitioners filed their Petition for Writ of Certiorari. (J.A.3). On November 12, 1985, this Court granted the Petition. (J.A.3).

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SUMMARY OF THE ARGUMENT

I. In interpreting the federal securities laws, this Court has always started with the statutory language. *See Landreth Timber Co. v. Landreth*, 105 S. Ct. 2297, 2301 (1985); *Teamsters v. Daniels*, 439 U.S. 551, 558 (1979); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756 (1975) (concurring opinion). The language of section 12(2) of the Securities Act of 1933 [hereinafter "section 12(2)"] does not provide that the recovery of "consideration paid" be reduced by "tax benefits." The "actual damages" limitation of section 28(a) of the Securities Exchange Act of 1934 [hereinafter "section 28(a)"] does not require that "tax benefits" be subtracted from damages awarded under section 10(b) of the Securities Exchange Act of 1934 [hereinafter "section 10(b)"] and Securities and Exchange Commission Rule 10b-5 [hereinafter "Rule 10b-5"]. The Eighth Circuit strayed from the appropriate starting point when it deducted "tax benefits" from recoveries under such statutes.

The Eighth Circuit first strayed from the statutory language by distinguishing between "tax shelters" and other securities and by adopting a rule which applies only to "tax shelters." Section 12(2), section 10(b), Rule 10b-5 and section 28(a) apply to *all* securities. There is no sta-

tutory language on which a special rule applicable only to "tax shelters" might be based.

The Eighth Circuit next strayed from the statutory language by defining "income received" to include "tax benefits." In *United Housing Foundation, Inc. v. Forman,* 421 U.S. 837, 855 (1975), this Court held that "payment of interest, with its consequent deductibility for tax purposes," did not constitute income within the context of the federal securities laws. In fact, "income" is

> compensation for services, . . . gross income derived from business, gains derived from dealings in property, interest, rents, royalties, dividends, . . . income from discharge of indebtedness [and] distributive share of partnership gross income.

26 U.S.C. § 61. "Tax benefits" are not included in the plain language of the statutory definition of "income." "Income" is taxable. *See* 26 U.S.C. §§ 1 & 11. "Tax benefits" are not. Because "tax benefits" are not "income," they should not be deducted from "consideration paid" when calculating the recovery available to a defrauded investor under section 12(2).

The Eighth Circuit also strayed from the statutory language by awarding interest on the "tax benefits." Such an award rewrites "the remedial language of the statute." *Johns Hopkins Univ. v. Hutton,* 297 F. Supp. 1165, 1231 (D. Md. 1968), *rev'd on other grounds,* 422 F.2d 1124 (4th Cir. 1970), *cert. denied,* 416 U.S. 916 (1974). Section 12(2) provides only for adding "interest" to the "consideration paid." The courts are not free to substitute their wisdom for the statutory language. *Id.*

The Eighth Circuit again strayed from the statutory language in interpreting the "actual damages" provision of section 28(a). The term "actual damages" appears only in the context of authorizing parallel state and fed-

eral remedies. It was designed only to prevent duplicative recoveries based on state and federal law. *E.g., Osofsky v. Zipf,* 645 F.2d 107, 111 (2d Cir. 1981).

II. The rule of *Hanover Shoe, Inc., v. United Shoe Mach. Corp.,* 392 U.S. 481, 503 (1968) and of *Norfolk & W. Ry. v. Liepelt,* 444 U.S. 490, 493-94 (1980) that taxes are to be taken into account in calculating the amount of recovery only when the recovery is tax-free remains sound. An investor in a "tax shelter" defers the payment of taxes. When the "tax shelter" is concluded, the investor must pay the taxes which he deferred. Because of changes in the investor's other income, changes in the Internal Revenue Code and variations in applicable marginal rates, the amount of taxes the investor actually pays in a later year may be greater or less than the amount would have been at the time the taxes would have been due but for the "tax shelter." The "rough result of not taking account of taxes for the year of injury but then taxing recovery" is "the most satisfactory outcome." *Hanover Shoe, Inc. v. United Shoe Mach. Corp.,* 392 U.S. at 503.

III. The purpose of the Securities Act of 1933

> is to protect the investing public and honest business. . . . The aim is to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investor; to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by dishonest securities offered to the public through crooked promotion . . . .

S. Rep. No. 47, 73d Cong., 1st Sess. 1 (1933), *reprinted in* 2 J. Ellenberger & E. Mahar, Legislative History of the Securities Act of 1933 & the Securities Exchange Act of 1934 (1973); *see also United States v. Naftalin,* 441 U.S. 768, 775 (1979); *SEC v. Capital Gains Research Bur-*

eau, Inc., 375 U.S. 180, 186-87 (1963). There is "no warrant for narrowing" the safeguards created by Congress. *See United States v. Gilliland*, 312 U.S. 86, 93 (1941).

The Eighth Circuit saw the function of section 12(2), section 10(b) and Rule 10b-5 only as one of compensating defrauded investors "for any actual monetary loss." Even if it were true that an award of $506 as of December 15, 1983, fully compensated an investor's actual monetary loss which had resulted from investing $35,000 in a worthless security on November 13, 1973, the award would not accomplish the statute's purpose in deterring fraud.

Fraud can be deterred only if investors have sufficient incentives to seek a recovery and thus to compel promoters to pay damages in amounts large enough to induce full disclosure. F. Easterbrook & D. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611, 620 (1985). The threat of civil liability is an important mechanism for coercing adequate disclosure. Only if the sanction of civil liability is sufficiently serious (and the damages sufficiently high) will fraud be deterred and accurate and complete information be provided to prospective investors. Note, *Real Estate Limited Partnerships & Allocational Efficiency: The Incentive to Sue for Securities Fraud*, 63 VA. L. REV. 669, 685 (1977).

ARGUMENT

I. THE INTERPRETATION OF SECTION 12(2) AND THE CALCULATION OF DAMAGES UNDER SECTION 10(b) AND RULE 10b-5 MUST BE CONSISTENT WITH THE LANGUAGE OF THE STATUTES AND THE RULE.

"The starting point" for the interpretation of the federal securities laws "is the language [of the statute]

itself." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. at 756 (concurring opinion); *accord, Landreth Timber Co. v. Landreth*, 105 S. Ct. at 2301; *Teamsters v. Daniels*, 439 U.S. at 558; *Ernst & Ernst v. Hochfelder*, 425 U.S. at 197. In attempting to interpret section 12(2) and to define the damages which section 28(a) permits to be recovered under section 10(b) and Rule 10b-5, the Eighth Circuit started at the wrong point. It disregarded the clear language and effectively rewrote the statutes under the guise of interpreting them.

When a court sets out to interpret a statute, it is to determine "only what the statute means." O. Holmes, *The Theory of Legal Interpretation*, 12 HARV. L. REV. 417, 419 (1898); *see also S & E Contractors, Inc. v. United States*, 406 U.S. 1, 14 n.9 (1972). If the language of a statute is plain, it is the duty of a court to enforce the statute as written. *United States v. Standard Brewery, Inc.*, 251 U.S. 210, 217 (1920). Absent a clearly expressed legislative intent to the contrary, the language of a statute must ordinarily be regarded as conclusive. *Consumer Prod. Safety Comm'n v. GTE Sylvania, Inc.*, 447 U.S. 102, 108 (1980). "In construing a federal statute it is appropriate to assume that the ordinary meaning of the language that Congress employed 'accurately expresses the legislative purpose.'" *Mills Music, Inc. v. Snyder*, 105 S. Ct. 638, 645 (1985).

A. There Is No Statutory Basis For Differentiating Between "Tax Shelters" And Other Securities.

Section 12(2) applies to all fraudulent sales of "a security" and provides the same remedy to all defrauded purchasers. Section 10(b) and Rule 10b-5 apply to "the purchase or sale of any security." Section 28(a) applies

to all suits for damages under section 10(b) and Rule 10b-5. Section 12(2), sections 10(b) and 28(a) and Rule 10b-5 say nothing about a special rule for suits seeking recovery on account of frauds related to "tax shelters."

The Eighth Circuit held that

> in a private securities fraud action involving an investment structured and marketed as a tax shelter, where a rescissory measure of damages is applied, evidence of any benefit derived by the plaintiff/investor via tax savings must be permitted.

Austin I at 183-84. The Eighth Circuit expressly restricted its holding "to cases involving investments that are expressly marketed and sold as tax shelters."[9] *Austin I* at 183; *accord, Austin II* at 954 (holding applies only to "special case of tax shelter investments").

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[9] Alotel Associates does not meet the definition of a "tax shelter" established by the Internal Revenue Code. *See* 26 U.S.C. § 6111(c)(1) ("tax shelter" means an investment represented as providing a "tax shelter ratio" for an investor "greater than 2 to 1" during any of first 5 years). The Offering Memorandum projected investment, deductions and credits as follows:

Year	*Investment*	*Deductions*	*Credits*
1973	$35,000	$20,395	$2,432
1974		14,695	
1975		2,960	
1976		476	
1977		(1,929)	

(Pl.Ex.2 at 27; Tr.42). Thus, the "tax shelter ratio" during the first 5 years was to be

Year	*Ratio*
1973	.72/1
1974	1.14/1
1975	1.23/1
1976	1.24/1
1977	1.18/1

See 26 U.S.C. § 6111(c)(2). Because the ratio was never represented as reaching 2 to 1, an investment in Alotel Associates could not be characterized as a "tax shelter."

That holding creates a distinction with no statutory basis. If there were to be a rule that "income" under section 12(2) includes "tax benefits" and that damages under section 10(b) and Rule 10b-5 must be reduced by "tax benefits," the rule should apply to all cases. There is no basis for distinguishing a fraudulent sale of a security "structured and marketed as a tax shelter" from a fraudulent sale of a security not so structured and marketed. Common stock, if it becomes worthless, generates a "tax benefit" for the investor. Yet, if the investor had purchased the stock in reliance on a misrepresentation and if the stock had become worthless, the Eighth Circuit would not reduce his recovery on account of the "tax benefits" he had obtained.[10]

The Eighth Circuit justified its distinction on the ground that the "tax benefits" were "bargained for." *Austin II* at 955. That justification ignores the obvious: every purchase of a security includes a "bargain" concerning the tax consequences. Every purchaser knows of and accepts the holding period for capital gains treatment, the deduction available if the security becomes worthless

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[10] An investor receives "tax benefits" in a variety of circumstances involving purchases of securities. He is permitted to take a loss when a security, *i.e.*, stock, bond, debenture or note, becomes worthless. *See* 26 U.S.C. § 165(g). He is permitted to reduce his taxable income on account of contributions to an individual retirement account, *see* 26 U.S.C. § 219, on account of a qualified reinvested stock dividend, *see* 26 U.S.C. § 305(b), on account of a contribution by a self-employed person to a pension or profit-sharing plan, *see* 26 U.S.C. § 401(c), and on account of a qualified cash arrangement by which he directed an employer to contribute to a qualified trust. *See* 26 U.S.C. § 401(k). He is permitted to elect to have a tax-exempt organization which employs him reduce his income and use the monies to purchase an annuity for him. *See* 26 U.S.C. § 403(b). Such deductions defer taxes in the same manner as does a "tax shelter" and thus create "tax benefits."

or is sold at a loss, etc. The purchase of a "tax shelter" differs only in the specifics of the "tax benefits" that were bargained for.

B. The Language Of Section 12(2) Does Not Allow Deduction Of "Tax Benefits" From A Defrauded Purchaser's Recovery.

Section 12(2)'s language is straightforward. The statute allows a defrauded purchaser

> to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security. . . .

The measure of recovery for a defrauded purchaser who still owns the security has three elements: (1) the consideration paid, (2) interest on the consideration and (3) income received.

1. "Tax Benefits" Are Not "Income."

The district court attempted to use "the ordinary meaning" of the term "income" in interpreting section 12(2). *Cf. Mills Music, Inc. v. Snyder,* 105 S. Ct. at 645. The district court found that there had been a timely tender of the limited partnership units, concluded that rescission was appropriate and refused to reduce the recovery under section 12(2) on account of "tax benefits." (Pet.App.D10,D17,E15-E16).

The Eighth Circuit rejected the district court's literal reading of section 12(2). Although it acknowledged that tax benefits received were not a form of income in a strict accounting sense, *Austin II* at 955, the Eighth Circuit nevertheless held that

> section 12(2)'s language "income *received* thereon" may properly be construed as including tax benefits bargained for and received . . . .

Austin II at 958 (emphasis in original).

The Eighth Circuit disregarded "the ordinary meaning" of the word "income."[11] "Income" normally means "gain derived from capital, from labor, or from both combined." *Eisner v. Macomber,* 252 U.S. 189, 207 (1920). "Tax benefits" are not gain derived from capital or labor.

In interpreting a term, courts are to use a "well-settled meaning" if one exists. *See Landreth Timber Co. v. Landreth,* 105 S. Ct. at 2302. "Income" carries a "well-settled meaning." 26 U.S.C. § 61 establishes the meaning of "income":

> compensation for services, . . . gross income derived from business, gains derived from dealings in property, interest, rents, royalties, dividends, . . . income from discharge of indebtedness [and] distributive share of partnership gross income.

"Tax benefits" are not included within that "well-settled meaning" of "income."[12]

Courts also look to "significant characteristics typically associated with" terms in attempting to interpret them. *See Landreth Timber Co. v. Landreth,* 105 S. Ct. at 2302; *United Housing Foundation, Inc. v. Forman,* 421 U.S. at 851. "Income" has "significant characteristics." One of those characteristics is taxability. "Tax benefits," of course, are not taxable. If deductions were "income," every taxpayer who took a deduction in one year would be required to include it within "gross income" on the fol-

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11 One commentator noted that *"Austin [I]* is without precedent in classifving tax benefits received by the plaintiff as 'income' within the meaning of section 12(2)." Note, *Austin v. Loftsgaarden: Securities Fraud in Real Estate Limited Partnership Investments,* 16 CREIGHTON L. REV. 1140, 1151 (1982).

12 Although "income" expressly includes a "distributive share of partnership gross income," 26 U.S.C. § 61(a)(1), it does not include "tax benefits" attributable to a distributive share of partnership losses.

lowing year's tax return. *Austin II* at 963 n.1 (dissenting opinion). No reported case or revenue ruling construes a deduction or credit as "income."[13] *See* 26 U.S.C. § 61.

In *United Housing Foundation, Inc. v. Forman,* 421 U.S. 837, this Court considered whether non-interest bearing shares in a non-profit housing cooperative were "investment contracts" and therefore "securities," as that term is used in section 2(1) of the Securities Act of 1933. An "investment contract" requires an "expectation of profits." The sellers therefore argued that the purchasers had bought the shares to obtain housing, not to obtain income or profits. The court of appeals disagreed, holding that profit might "be derived from the income yielded by an investment," *id.* at 855, and that one source of such income was "tax deductions for the portion of the monthly rental charges allocable to interest payments on the mortgage." *Id.* at 846.

This Court reversed, stating that the conclusion that tax deductions are a "supposed source of income or profits may be disposed of summarily." *Id.* at 855. It held that income or profits means "either capital appreciation resulting from development of the initial investment . . . or a participation in earnings resulting from the use of the investors' funds," *id.* at 852, and concluded:

> We know of no basis in law for the view that the payment of interest, with its consequent deductibility for tax purposes, constitutes income or profits.

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[13] Respondents themselves did not argue that tax benefits constituted income. *Austin II* at 958 ("Loftsgaarden argues that . . . tax benefits are a return of 'consideration paid' "). Respondents' own expert also testified that "tax benefits" were not "income." (R.178). The district court took "judicial notice that [Randall] didn't receive any income." (R.179).

Id. at 855. If "tax benefits" do not constitute income or profits under section 2(1), then "tax benefits" should not be considered income under section 12(2).[14]

"Income," as used in section 12(2), does not include every favorable economic consequence. In *Johns Hopkins Univ. v. Hutton,* 297 F. Supp. at 1232, payments made by the seller to defrauded purchasers intended to be applied to taxes were held not to be "income" under section 12(2). *See also* M. Kaminsky, *An Analysis of Securities Litigation under Section 12(2),* 13 Hous. L. Rev. 231, 281 (1976); 5C A. Jacobs, Litigation & Practice Under Rule 10b-5 § 260.03[c][vi] at 11-56 n.3 (2d ed. 1985); 26 U.S.C. § 61.

The Eighth Circuit rationalized that its expansive interpretation of "income" reflected "economic reality" and that to ignore "tax benefits actually realized . . . would be unrealistic." *Austin II* at 955 & n.9. That rationalization flies in the face of a cardinal principle of rescission: "[t]he goal of rescission under section 12(2) is to return the parties to the status quo ante." *Austin II* at 954. The Eighth Circuit purports to return Petitioners to the status quo ante, but it never purports to return Respondents to the status quo ante or to require them to disgorge their unlawfully obtained profits. As the dissent noted:

> There was evidence at trial showing Loftsgaarden received over $100,000 profit from the investment scheme. Under the majority's approach, Loftsgaarden

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[14] The Eighth Circuit tried to distinguish *United Housing Foundation* by characterizing the tax benefits at issue there as "marginal" and those now at issue as "the primary motivation behind the investment." *Austin II* at 955. Such a distinction should be of no consequence. Nothing in section 12(2) contemplates substracting substantial "tax benefits" from damages but ignoring marginal ones.

> gains both his own profit from the scheme and the advantage of plaintiffs' speculative tax benefits.[15]

Austin II at 963 (dissenting opinion).

The Eighth Circuit's rationalization also assumes that "tax benefits" would provide a "windfall" to defrauded purchasers unless those "tax benefits" were deducted from their recoveries. The Eighth Circuit therefore chose to award the "windfall" to defrauding sellers. Even if a defrauded purchaser were to obtain a windfall, it would be "more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them."[16] *Myzel v. Fields*, 386 F.2d 718, 747 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); *Janigan v. Taylor*, 344 F. 2d 781, 786 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965); *see also Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1305 (2d Cir. 1973); *Johns Hopkins Univ. v. Hutton*, 297 F. Supp. at 1226.

The Eighth Circuit's rationalization also ignores the legislative history. That history demonstrates that a defrauded purchaser is to obtain his recovery from the seller. H.R. Rep. No. 85, 73d Cong., 1st Sess. 9 (1933), *reprinted in* 2 J. Ellenberger & E. Mahar, Legislative History of the Securities Act of 1933 & the Securities Exchange Act of 1934 (1973) (defrauded purchaser can "sue for recovery of his purchase price"); S. Rep. No. 47, 73d Cong. 1st Sess.

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15 The evidence showed that PDRC received no less than $80,490, that 2361 received no less than $213,334 and that arc-TECH, inc., received $90,000.

16 Petitioners will get no windfall. Any recoveries will be subject to tax. Furthermore, it would be

> reasonable to assume that if plaintiffs had not invested in Loftsgaarden's fraudulent scheme, they would have invested in another legitimate project which would have returned similar tax benefits as well as principal and interest over the life of the investment. . . .

Austin II at 964 n.2 (dissenting opinion).

6 (1933), *reprinted in* 2 J. Ellenberger & E. Mahar, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 & THE SECURITIES EXCHANGE ACT OF 1934 (1973) (defrauded purchaser can "sue for a return of his money"); 77 Cong. Rec. 2913 (1933) (defrauded purchaser can get his "money back" from seller).

2. "Interest" Should Not Be Added To "Tax Benefits" Even If "Tax Benefits" Were To Be Considered "Income Received."

The Eighth Circuit compounded its error by subtracting interest on the "tax benefits" from the "consideration paid." *Austin II* at 959. That further reduces a defrauded purchaser's recovery under section 12(2). After remand, the district court had stated:

> The clear language of [section] 12(2) presents the order in which to consider these items: "consideration paid . . . with interest thereon, less the amount of any income received . . . ." These words present an express directive to this court, and [the] defendant[s] cite no cases directly on point which hold to the contrary.

(Pet.App.C7). The Eighth Circuit reversed. It conceded that the result of its holding as to section 12(2) was to permit a defrauded purchaser "to recover the amount paid for [the security] with interest, less the amount received with interest." *Austin II* at 959, *quoting Murphy v. Cady*, 30 F. Supp. 466, 470 (D. Me. 1939), *aff'd* 113 F.2d 988 (1st Cir.), *cert. denied*, 311 U.S. 705 (1940).

Section 12(2) mandates recovery of "the consideration paid for the security with interest thereon, less the amount of any income received thereon." The Eighth Circuit effectively rewrote the latter portion of the statute to read "less the amount of any income received thereon

with interest thereon." The words "interest thereon" modify only "consideration paid." The word "thereon" has no other antecedent. Interest is to be added only to the "consideration paid," and "income received" is then to be subtracted from the sum. *See Johns Hopkins Univ. v. Hutton*, 297 F. Supp. at 1231 [adding interest to "income received" under section 12(2) would be proper only if court had "power, to in effect, rewrite the remedial language of the statute"].

C. Nothing In Section 28(a) Justifies Reducing Damages Under Section 10(b) And Rule 10b-5 By "Tax Benefits."

Damages under section 10(b) and Rule 10b-5 are limited by section 28(a). Section 28(a) provides:

> The rights and remedies provided by [the Securities Exchange Act of 1934] shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of [the Securities Exchange Act of 1934] shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of . . . .

The Eighth Circuit concluded that "a plaintiff can recover no more than his 'net economic loss' " and held that "net economic loss" was to be equated with "actual damages." *Austin II* at 954; *accord, Salcer v. Envicon Equities Corp.*, 744 F.2d 935, 940 (2d Cir. 1984), *petition for cert. filed*, 53 U.S.L.W. 3688 (U.S. Mar. 13, 1985) (No. 84-1447).

That interpretation begs the question of what is intended by the term "actual damages." A careful examination of section 28(a) and of other statutes that use the term and a review of judicial construction of the term demonstrate that "actual damages" does not require a reduction of damages on account of "tax benefits."

First, the sentence structure of section 28(a) suggests that Congress meant only to prevent duplicative recoveries when a plaintiff asserted a state law claim as well as a federal securities law claim. The first clause of section 28(a) provides that federal remedies do not preempt state remedies. The phrase "actual damages" prevents a plaintiff from recovering more than once if he pursues both federal and state causes of action.[17] *E.g., Osofsky v. Zipf*, 645 F.2d at 111.

Second, although Congress did not define the term "actual damages" when it enacted section 28(a), the term already had an accepted meaning. The term was used in statutes governing patent, copyright and trademark infringement. *See* 35 U.S.C. § 67 (1928); 17 U.S.C. § 25 (1928); 15 U.S.C. §§ 16-19 (1928).

This Court had defined the term "actual damages," as used in the patent statutes, to require damages to be "given as a compensation, recompense, or satisfaction to the plaintiff, for an injury actually received." *Birdsall v. Coolidge*, 93 U.S. 64 (1876). The copyright and trademark statutes allowed a plaintiff to recover both his "injury" and the infringer's "profits" and equated "injury" and "profits" with "actual damages." *See* 17 U.S.C. § 25 (1928); 15 U.S.C. § 19 (1928).

In *L. P. Larson, Jr., Co. v. William Wrigley, Jr., Co.*, 277 U.S. 97 (1928), this Court refused to deduct income taxes from a recovery for trademark infringement. This Court held:

> To review one of these questions a writ of certiorari was granted by this court. That question is whether

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[17] A strict construction of section 28(a), which refers only to "a suit for damages," may preclude any limitation on the equitable remedy of rescission. *See* Note, *Insiders Liability under Rule 10b-5 for the Purchase of Actively Traded Securities*, 78 YALE L.J. 864, 874 n.51 (1969).

> . . . the Wrigley Company should be allowed to deduct the Federal income and excess profits taxes from the profits with which it is to be charged.
>
> * * *
>
> Even if the only relief that the Wrigley Company can get is a deduction from gross income when the amount of its liability is finally determined, the Larson Company will have to pay a tax on the Wrigley profits when it receives them, and in a case of what has been found to have been one of conscious and deliberate wrongdoing, we think it just that the further deduction should not be allowed.

Id. at 99-100. Thus, when the Securities Exchange Act of 1934 became law, the term "actual damages" did not require damages to be reduced because of tax consequences.[18]

The reasoning behind the judicial refusal to credit an infringer with the taxes paid on the profits being recovered in patent, copyright and trademark cases applies equally to securities fraud cases. Recovery for patent, copyright or trademark infringement is not reduced by

> income taxes . . . since plaintiffs will be required to pay income taxes on any amount recovered and should not have that amount diminished . . . .

Carter Prod., Inc. v. Colgate-Palmolive Co., 214 F. Supp. 383, 406 (D. Md. 1963). Recoveries in securities fraud cases are also taxable and also should not be diminished.

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[18] Subsequent patent, copyright and trademark cases continued to apply the rule and refused to consider tax consequences when computing damages. *See, e.g., Wolf v. National Lead Co.*, 272 F.2d 867, 873 (9th Cir. 1969) (income taxes paid by infringer are not a proper deduction when accounting for a trademark infringer's profit); *Alfred Bell & Co. v. Catalda Fine Arts, Inc.*, 191 F.2d 99, 106 (2d Cir. 1951) (error to allow deduction when accounting for a copyright infringer's profits); *Sheldon v. Metro-Goldwyn Pictures Corp.*, 106 F.2d 45, 53 (2d Cir. 1939), *aff'd*, 309 U.S. 390 (1940); *Goodyear Tire & Rubber Co. v. Overman Cushion Tire Co.*, 95 F.2d 978, 985 (6th Cir. 1937) (no deduction from profits for income taxes paid by patent infringer).

Third, deducting tax benefits from damages gives a defrauder the benefit of provisions of the Internal Revenue Code that were structured to benefit investors. The Eighth Circuit expressed concern that, if Respondents were to retain the "tax benefits," Respondents would reap a windfall, *i.e.*, something in excess of their "actual damages." This Court has not seen fit to interpret "actual damages" to restrict recoveries in any such way. In *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), defrauded sellers sought to recover profits earned by the defrauder. The defrauder objected that such a recovery was precluded by the "actual damages" limitation of section 28(a). This Court held that the "actual damages" limitation does not prevent recoveries constituting "more than the [defrauded] seller's actual loss" in actions under section 10(b). *Id.* at 155.

Thus the "actual damages" limitation does not prevent a plaintiff from recovering a "windfall," *Myzel v. Fields*, 386 F.2d at 747; *Janigan v. Taylor*, 344 F.2d at 786, nor does it prevent a plaintiff from recovering more than his "actual loss." *Affiliated Ute Citizens v. United States*, 406 U.S. at 155. Neither should the limitation prevent a plaintiff from recovering damages in reduction by "tax benefits."

II. PERMITTING DEFRAUDED PURCHASERS TO RECOVER THEIR "CONSIDERATION PAID . . . WITH INTEREST" WITHOUT A REDUCTION FOR "TAX BENEFITS" IS CONSISTENT WITH PRECEDENT.

A. The Eighth Circuit's Decision Fails To Defer To This Court's Precedent.

The Eighth Circuit's decision that recoveries for securities fraud must be reduced by "tax benefits" cannot be reconciled with this Court's decisions. The impact of

taxes on recovery is the subject of a number of significant opinions.

In *Hanover Shoe, Inc. v. United Shoe Mach. Corp.*, 392 U.S. 481, this Court first addressed a party's argument that an adversary's damages must be reduced to the "after-tax profits that [the adversary] failed to receive." *Id.* at 503. This Court held that

> to diminish the actual damages by the amount of taxes that [a plaintiff] would have paid had it received greater profits in the years it was damaged would be to apply a double deduction for taxation, leaving [the plaintiff] with less income than it would have had if [the defendant] had not injured it.

Id. This Court, recognizing the changing rates of taxation, expired statutes of limitation and difficulties in recomputing taxes that would have accrued over a period of years, stated that

> the rough result of not taking account of taxes for the year of injury but then taxing recovery when received seems the most satisfactory outcome,

id., and held that damages should equal pre-tax profits and that the IRS should be permitted to tax the recovery. *Id.*

In *Norfolk & W. Ry. v. Liepelt*, 44 U.S. 490, this Court held that it was necessary to instruct a jury that a damage award would not be taxable. *Id.* at 491. This Court recognized that an injured individual's after-tax income, not his gross income before taxes, was the relevant factor in calculating the damages sustained by his dependents when he died. *Id.* at 493-94. This Court again recognized the complexities in predicting the many variables; nevertheless, it held that the danger of overcompensation based on an erroneous assumption concerning taxability required the admission of expert testimony concerning income tax

liability for future wages and the giving of an instruction that a judgment would not be taxable. *Id.* at 497-98.

In *Jones & Laughlin Steel Corp. v. Pfeifer,* 462 U.S. 523 (1983), this Court offered guidance to those seeking to reconcile *Hanover Shoe* with *Liepelt.* This Court stated that, when the damages award itself is to be tax-free, the evidence to be considered is that concerning "after-tax" amounts. It implied that, when the damage award itself is taxable, evidence of taxes paid or to be paid should be excluded. *Id.* at 547-51.

The Eighth Circuit applied *Liepelt* to Petitioners' claims for damages even though it recognized that each would "have to pay taxes on his award." The Eighth Circuit failed to consider *Hanover Shoe* or *Pfeiffer.* In doing so, the Eighth Circuit glossed over *Liepelt's* predicate that its holding applied only when an award of damages is not taxable.

B. The Eighth Circuit's Decision Fails To Defer To Other Precedent.

Courts interpreted the federal securities laws and provided remedies to defrauded purchasers for over thirty years before the deductibility of tax benefits surfaced as an issue in a reported decision. *See Cooper v. Hallgarten & Co.,* 34 F.R.D. 482 (S.D.N.Y. 1964). When defendants first argued that a plaintiff's recovery should be reduced by an amount equal to the tax benefits flowing from an investment, court uniformly rejected those arguments. *See, e.g., Rhode v. Hershberger Explorations, Inc.,* 349 F. Supp. 993, 994 (D. Minn. 1972); *Johns Hopkins Univ. v. Hutton,* 297 F. Supp. at 1232; *Wiesenberger v. W. E. Hutton & Co.,* 35 F.R.D. 556, 557 (S.D.N.Y. 1964); *Cooper v. Hallgarten & Co.,* 34 FR.D. at 484; *see also Chris-Craft Indus., Inc., v. Piper Aircraft Corp.,* 480 F.2d 341, 391

(2d Cir.), *cert. denied,* 414 U.S. 910 (1973) ("party seeking rescission must return any proceeds . . . received from the transaction being rescinded [but] the proceeds that must be returned are [only] those received from the other party").

Some courts eventually permitted discovery concerning "tax benefits" because information discovered might be relevant to issues other than damages. Courts which permitted such discovery considered it relevant to valuation of the investment, *see Dupuy v. Dupuy,* 551 F.2d 1005, 1025 (5th Cir.), *cert. denied,* 434 U.S. 911 (1977); *Smith v. Bader,* 83 F.R.D. 437, 439 (S.D.N.Y. 1979); *cf. Berg v. Xerxes-Southdale Office Bldg. Co.,* 290 N.W.2d 612, 615 (Minn. 1980), to misrepresentation of tax benefits, *Bridgen v. Scott,* 456 F. Supp. 1048, 1062 (S.D. Tex. 1978); *Bayoud v. Ballard,* 404 F. Supp. 417, 426 (N.D. Tex. 1975), to causation, *see Houlihan v. Anderson-Stokes, Inc.,* 78 F.R.D. 232, 234 (D.D.C. 1978), to reliance, *see Smith v. Bader,* 83 F.R.D. at 439; *Sharp v. Coopers & Lybrand,* 83 F.R.D. 343, 352 (E.D. Pa. 1979), *rev'd on other grounds,* 649 F.2d 175 (3d Cir. 1981), *cert. denied,* 455 U.S. 938 (1982), and to laches. *See Hickman v. Groesbeck,* 389 F. Supp. 769, 780 (D. Utah 1974). Other courts continued to consider tax benefits wholly irrelevant. *E.g., Spatz v. Borenstein,* 513 F. Supp. 571, 576-86 (N.D. Ill. 1981); *see also Borovoy v. Bursar Realty Corp.,* 86 Mich. App. 732, 738, 273 N.W.2d 545, 548 (1979) (tax consequences "do not enter into the computation of damages" under Michigan's securties laws); *G & R Corp. v. American Sec. & Trust Co.,* 523 F.2d 1164, 1173-74 (D.C. Cir. 1975) (contract damages not to be offset by tax benefits).

The Eighth Circuit was the first to require that a recovery be reduced by tax benefits. *Austin I* at 183; Note, *Austin v. Loftsgaarden: Securities Fraud in Real Estate*

Limited Partnership Investments, 16 CREIGHTON L. REV. at 1151. Most other courts rejected the Eighth Circuit's approach. *E.g., Western Fed. Corp. v. Erickson*, 739 F.2d 1439, 1444 (9th Cir. 1984); *Burgess v. Premier Corp.*, 727 F.2d 826, 837-38 (9th Cir. 1984); *Koehler v. Pulvers*, [Current] FED. SEC. L. REP. (CCH) ¶ 92,232 at 91,671 (S.D. Cal. 1985); *Hokama v. E. F. Hutton & Co.*, 566 F. Supp. 636, 847-48 (C.D. Cal. 1983); *see also Eisenberg v. Gagnon*, 766 F.2d 770, 782 (3d Cir. 1985) (deductibility of losses not to be considered in assessing damages); *Danzig v. Jack Grynberg & Assoc.*, 161 Cal. App. 3d 1128, 1139-40, 208 Cal. Rptr. 336, 343-44 (1984), *cert. denied*, 106 S. Ct. 67 (1985) (limited partners' tax consequences irrelevant to their rescissionary recovery based upon misrepresentation); *Harris v. Metropolitan Mall*, 112 Wis. 2d 487, 501-02, 334 N.W.2d 519, 526 & n.21 (1983) (tax consequences of "tax shelter" do not reduce restitutionary recovery). The Second Circuit, however, adopted the Eighth Circuit's approach. *See Freschi v. Grand Coal Venture*, 767 F.2d 1041, 1050-51 (2d Cir. 1985), *petition for cert. filed*, 54 U.S.L.W. 3154 (U.S. Sept. 6, 1985) (No. 85-377); *Salcer v. Envicon Equities Corp.*, 744 F.2d at 940-44.

C. Deducting "Tax Benefits" From Recoveries For Securities Fraud Disregards The Collateral Source Rule.

The Eighth Circuit's decision vitiates the "collateral source" rule. The rule is set forth in RESTATEMENT (SECOND) OF TORTS § 920A(2) (1979):

> Payments made to or benefits conferred on [an] injured party from other sources are not credited against the tortfeasor's liability, although they cover all or a part of the harm for which the tortfeasor is liable.

The rule means that

> a benefit that is directed to the injured party should not be shifted so as to become a windfall for the tortfeasor. If the plaintiff was himself responsible for the benefit, as by maintaining his own insurance or by making advantageous employment arrangements, the law allows him to keep it for himself. If the benefit was a gift to the plaintiff from a third party or established for him by law, he should not be deprived of the advantage that it confers. The law does not differentiate between the nature of the benefits, so long as they did not come from the defendant or a person acting for him.

Id. comment b.

The Eighth Circuit held that

> the tax benefits of plaintiffs' investments are not a collateral source because "although paid by the government, [they] emanate directly from the tax shelter sought by the plaintiffs and provided by defendants, without which plaintiffs could not have realized any tax benefits. Benefits resulting directly from a transaction under attack must be credited toward the damage award.

Austin II at 956, *quoting Salcer v. Envicon Equities Corp.*, 744 F.2d at 941-42. That analysis misconstrues the nature of a "collateral source."[19]

Every collateral source results "directly" from the tort or transaction at issue; otherwise, no defendant could claim to reduce his obligation based on a payment from the "collateral source." Health and disability insurance payments come from a "collateral source" and do not re-

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[19] The analysis fails to acknowledge that there would be no "tax benefits" but for a defrauded purchaser's income from other sources.

duce the damage for which the tortfeasor is liable even though the injury and hence the insurance payments result "directly" from the tort. The rule applies even if the tortfeasor contributes to a fund which provides the benefits. *E.g., Eichel v. New York Cent. R.R.*, 375 U.S. 253, 254-55 (1963); *NLRB v. Gullett Gin Co.*, 340 U.S. 361, 364 (1951); *Kauffman v. Sidereal Corp.*, 695 F.2d 343, 346-47 (9th Cir. 1982).

The proper question is whether the benefit is conferred on an injured party from a source other than the defendant. RESTATEMENT (SECOND) OF TORTS § 920A(2). Petitioners' "tax benefits" come from a third party, *i.e.*, the government, and are calculated based on Petitioners' other income. R. Thompson, *The Measure of Recovery under Rule 10b-5*, 37 VAND. L. REV. 349, 390 (1984) ("plaintiff who receives a tax benefit obtains his advantage from the government, not from the defendant"). Petitioners' "tax benefits" do not come from Respondents. Because the "tax benefits" were established for [them] by law," Petitioners "should not be deprived of the advantage" created. *See* RESTATEMENT (SECOND) OF TORTS § 920A(2) comment b; *Funston v. United States*, 513 F. Supp. 1000, 1010 (M.D. Pa. 1981) ("tax benefit conferred by [the state] is from a collateral source"); *Iowa-Des Moines Nat'l Bank v. Schwerman Trucking Co.*, 288 N.W.2d 198, 205 (Iowa 1980) ("tax saving [is to be] treated as a collateral source"); *Cereal Byproducts Co. v. Hall*, 16 Ill. App. 2d 79, 81, 147 N.E.2d 383, 384, *aff'd*, 15 Ill. 2d 313, 155 N.E.2d 14 (1958) (tax consequences of theft loss treated as being from collateral source); *Lumber Terminals, Inc. v. Nowakowski*, 36 Md. App. 82, 97, 373 A.2d 2[illegible], 291-92 (1977) ("[t]axes are strictly between plaintiff as taxpayer and

the government as collector, and are of no legitimate concern of the defendants'').

III. PUBLIC POLICY CONSIDERATIONS REQUIRE THAT "TAX BENEFITS" NOT BE SUBTRACTED FROM SECURITIES FRAUD RECOVERIES.

This Court often considers practical factors and considerations of policy in explicating congressional intent. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. at 749. All practical and policy considerations require courts to disregard "tax benefits" in calculating recoveries under the federal securities laws.

A. Subtracting "Tax Benefits" From Securities Fraud Recoveries Undermines The Disclosure Requirements Of The Federal Securities Laws.

In 1933 President Roosevelt appealed to Congress in seeking passage of the Securities Act of 1933:

> This proposal adds to the ancient rule of caveat emptor, the further doctrine, "Let the seller also beware." It puts the burden of telling the whole truth on the seller. *It should also give impetus to honest dealing in securities* . . . .

77 Cong. Rec. 937 (1933) (emphasis added). The preamble to the Securities Act states that its purpose is to

> provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and *to prevent frauds* in the sale thereof . . . .

47 Stat. 74 (1933) (emphasis added). When it became law, the Securities Act of 1933 created "a system of full disclosure." T. Hazen, THE LAW OF SECURITIES REGULATION

§ 1.2 at 7 (1985); *see also* 1 L. Loss, SECURITIES REGULATION 184 (2d ed. 1961). The Securities Exchange Act of 1934 is intended to regulate all aspects of the public trading of securities, bars material misstatements and omissions and requires full disclosure. T. Hazen, THE LAW OF SECURITIES REGULATION § 1.2 at 7; *see also* 1 L. Loss, SECURITIES REGULATION 184.

The Securities Act of 1933 and the Securities Exchange Act of 1934 implement the requirement of full disclosure by five primary means: (1) SEC examination of registration documents to determine compliance with the laws' disclosure requirements, (2) SEC initiation of injunction proceedings, (3) SEC administrative hearings and sanction procedures, (4) criminal prosecutions and (5) private litigants' suits for restitution and damages. T. Hazen, THE LAW OF SECURITIES REGULATION § 1.3 at 10-11; 1 L. Loss, SECURITIES REGULATION 302-03; 2 L. Loss, SECURITIES REGULATION 845-57 (2d ed. 1961); T. Hazen *Administrative Enforcement: An Evaluation of the SEC's Use of Injunctions & Other Enforcement Methods,* 31 HASTINGS L.J. 427 (1979); S. REP. No. 47, 73d Cong., 1st Sess. 6 (1933), *reprinted in* 2 J. Ellenberger & E. Mahar, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 & THE SECURITIES EXCHANGE ACT OF 1934 (1973); *see also United States v. Naftalin,* 441 U.S. at 778; *Red Bank Oil Co.,* 20 S.E.C. 863, 866 (1945).

The Securities Act of 1933 exempts certain securities from its registration requirements because of the "small amount involved" or because of the limited character of

the public offering, 15 U.S.C. § 77c, and exempts certain transactions because of the nature of the transactions or the participants. 15 U.S.C. § 77d. Most limited partnership offerings[20] fall within one or more exemptions.[21] Therefore, the SEC has no opportunity to examine documents prior to sale. Because neither the SEC nor the Department of Justice has the resources to police all of the fraudulent activity by organizers of limited partnerships,[22] the primary tool in enforcing the disclosure requirements is the private civil action. Note, *Real Estate Limited Partnerships & Allocational Efficiency: The Incentive to Sue for Securities Fraud,* 63 VA. L. REV. at 670-71.

The incentive to make full disclosure thus is in direct relation to the likelihood and risk of a successful suit. *Id.* at 671; *see also* F. Easterbrook & D. Fischel, *Optimal Damages in Securities Cases,* 52 U. CHI. L. REV. at 614-30. The Eighth Circuit's decision makes it unlikely that

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20 The total invested in limited partnerships in 1983 was estimated to be $8.4 billion. TIME, Nov. 26, 1984 at 26. The total invested in 1984 was estimated to be $19 billion. 4 R. Haft & P. Fass, TAX SHELTERED INVESTMENTS vii (3d ed. 1985). In 1980 there were approximately 211,000 real estate limited partnerships in existence. Bureau of Nat'l Affairs, Inc., *Daily Report for Executives* (Feb. 21, 1984).

21 In a 12 month period during 1975-1976 only 10 limited partnerships were registered with the SEC. [1976] 5 FED. SEC. L. REP. (CCH) at 64,214. In a similar period during 1984-1985 less than 60 real estate limited partnerships were registered. [1985] 6 FED. SEC. L. REP. (CCH) Br. 5 & 6 at 64,264-77.

22 Fraud continues to grow despite the efforts of federal and state enforcement agencies. *Washington Post,* Jun. 4, 1984, at A-11.

defrauded investors will sue and minimizes the risk to the fraudulent promoter in the unlikely event that they do sue. Note, *Real Estate Limited Partnerships & Allocational Efficiency: The Incentive to Sue For Securities Fraud,* 63 VA. L. REV. at 671-72. One commentator described the Eighth Circuit's message to potential promoters:

> Relax. Should a violation of the securities law occur, promoters in the Eighth Circuit apparently need only assure themselves that the investors get a large enough tax deduction.

Note, *Austin v. Loftsgaarden: Securities Fraud in Real Estate Limited Partnership Investments,* 16 CREIGHTON L. REV. at 1152.

Allowing the Eighth Circuit's decision to stand encourages promoters to omit or to misrepresent information material to potential investors. Like Loftsgaarden, those promoters will hope to pocket in excess of $100,000, *see Austin II* at 963 (dissenting opinion), to keep all of the money for twelve years and then to return less than $30,000. The decision will discourage investors who look at Randall and see only a man who invested $35,000 as a result of a fraud, who spent $7,500 in loans and other thousands of dollars trying to salvage his investment and who was left with nothing but an expenditure of more than ten years and additional thousands of dollars in attorney's fees in pursuit of his recovery of $506.

This Court must insist on the disclosure required by statute. To do so, it must insure the continued viability of the express and implied remedies for violations of the

securities laws' disclosure requirements. To do otherwise is to undercut the protective purpose of the securities laws. *See* R. Thompson, *The Measure of Recovery under Rule 10b-5,* 37 VAND. L. REV. at 390 ("[f]ocusing on the defendant and resolving doubts against the party committing the fraud is consistent . . . with the dual deterrent/compensatory purposes of the federal securities laws" and requires that there be no deduction for tax benefits); *United States v. Naftalin,* 441 U.S. at 774-77.

B. Subtracting "Tax Benefits" From Securities Fraud Recoveries Effectively Transfers Monies From The Treasury To The Defrauder.

By crediting a promoter who defrauded investors with "tax benefits" conferred by the government, the Eighth Circuit makes the "government . . . the banker for fraudulent tax shelter activity." *Burgess v. Premier Corp.,* 727 F. 2d at 838. Because a defrauded purchaser's recovery is taxable, he will not retain all of it. Taxation will transfer a part of the recovery to the public treasuries from which the "tax benefits" first came.

> [T]o simply subtract the tax benefits from damages would place an unfair burden on taxpayers generally . . . . Such a result leaves the government bearing the costs of [a seller's] fraud. A better result is to set damages equal to [the defrauded purchaser's] losses exclusive of tax benefit.

Id.

In calling for enactment of the Securities Act of 1933, President Roosevelt cautioned that

> the Federal Government cannot and should not take any action which might be construed as . . . guaranteeing that newly issued securities are sound in the sense that their value will be maintained.

77 Cong. Rec. 937 (1933). The securities laws still do not guarantee the "value" of securities. However, the Eighth Circuit's

> holding provides the wrongdoer a surety by which to avoid liability, allowing the fraudulent party to use the United States Treasury for security in any fraudulent transaction. To the extent a defendant can, by his wrongful act, create a tax loss for the innocent victim, the defendant will be allowed to escape liability, shifting the burden of the loss onto the government.

Austin II at 964 (dissenting opinion). That is something neither President Roosevelt nor the Congress would ever have imagined: the government now provides a guarantee, not for the investor, but for the fraudulent promoter.

C. Subtracting "Tax Benefits" From Securities Fraud Recoveries Creates Anomalous Damage Awards.

The Eighth Circuit decision creates anomalous damage awards. Investors in different tax brackets, but identically situated in every other way, would receive awards which vary widely. The differences are based upon factors which have nothing to do with the investments or with the frauds which occasioned the awards. Even though Randall, Austin and Anderson each invested $35,000 in Alotel Associates and even though none received any cash or cash equivalent as a return on his investment, Randall is to recover $506, Austin $7,666 and Anderson $18,790. *Id.* at 961; *compare Hayden v. McDonald*, 742 F.2d 423, 425, 439 (8th Cir. 1984) (56 plaintiffs and presumably 56 different results). Disparate treatment of investors based upon differences in their taxable income undermines the

purposes of the federal securities laws. *See Herman & MacLean v. Huddleston,* 459 U.S. 375, 390 (1983) (defrauded investors are persons securities laws seek to protect).

Furthermore, the Eighth Circuit decision enables plaintiffs and defendants to manipulate the amount of damages. Because "tax benefits" depend upon an investor's ordinary income and marginal tax bracket, a plaintiff may control the timing of his receipt of ordinary income and thereby increase his damages. A defendant may also control the amount of "tax benefits" (and of damages) by his own ability to make elections. S. Banoff, *To What Extent Will Benefits from Tax Shelters be Permitted to Offset Rescission Damages,* 57 J. TAXATION 154, 155-56 (1982).

D. Subtracting "Tax Benefits" From Securities Fraud Recoveries Does Not Fully Compensate Defrauded Investors.

The Eighth Circuit held that the words "income received" in section 12(2) include all economic benefits bargained for and received, including "tax benefits."[23] *Austin II* at 955. The holding misapprehended the nature and effect of a "tax shelter."

The "tax benefits" which an investor obtains through a "tax shelter" are no more than a deferral of taxes. *Aus-*

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[23] The Eighth Circuit never considered Respondents' tax consequences. Payment of rescissionary damages will result in a business expense which can be deducted from ordinary income; actual rescission will result in a short-term capital loss. Both will result in "tax benefits" to Respondents. If the Eighth Circuit's reasoning is to be followed, Petitioners, as the ones who bestowed the "tax benefits" on Respondents, should be able to recover them from Respondents.

tin II at 963 (dissenting opinion). The district court found that Petitioners "were not actually going to make any money because of tax losses" and were getting only a tax deferral. (Pet.App.F6). Indeed, the Eighth Circuit panel recognized that Petitioners' investments in Alotel Associates served "only to defer taxation until the investment is liquidated and each partner receive[d] his . . . proportional share of the proceeds of the sale." *Austin I* at 174.

The Eighth Circuit treated "tax benefits" as "permanent" because the relevant tax years were "closed." *Austin II* at 955. The Internal Revenue Code does contain a three-year statute of limitation, 26 U.S.C. § 6501(a), and more than three years have passed, (Def.Ex.1A,1B,1C; R. 42-43,62), but the final tax consequences of the original investment and the subsequent recovery are not yet determined.

The Eighth Circuit itself acknowledges that a defrauded purchaser who recovers will be taxed on his recovery. *Austin II* at 960. At the time of recovery taxes may be imposed as a result of a purchaser's amendment of his earlier tax returns. Taxes may be imposed under the mitigation provisions of the Internal Revenue Code, which permit correction of the effect of an error even if the statute of limitation would otherwise prevent correction. 26 U.S.C. §§ 1311-14. Taxes may be imposed under the tax benefit rule's requirement that a recovery be taxed as ordinary income.

The Ninth Circuit correctly understood the consequences of a "tax shelter"; it held:

> While we agree that consideration of tax consequences is relevant for certain purposes, we decline to make the government the banker for fraudulent tax shelter

> activity. Judge Hardy's analysis in *Western Federal Corp. v. Davis*, 553 F. Supp. 818, 820 (D. Ariz. 1982) is correct in discerning that the economic benefit by way of tax deductions is illusory because amended returns will have to be filed . . . .

Id.; accord, Western Fed. Corp. v. Erickson, 739 F.2d at 1444; *Rhode v. Hershberger Explorations, Inc.*, 349 F. Supp. at 994 ("[t]o the extent recovery is had, amended income tax returns will have to be filed").

Rescission may invoke the mitigation provisions. Section 12(2) allows a defrauded purchaser to rescind. *Wigand v. Flo-Tek, Inc.*, 609 F.2d 1028, 1035 (2d Cir. 1979). Section 29(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78cc(b), declares contracts "made in violation of" section 10(b) or Rule 10b-5 to be "void." Thus, a defrauded purchaser who can demonstrate a violation of section 10(b) or Rule 10b-5 can sue for and obtain recission. *E.g., Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 387-88 (1970); *Regional Properties, Inc., v. Financial & Real Estate Consulting Co.*, 678 F.2d 552, 558 (5th Cir. 1982). Recission voids the underlying transactions from the inception and returns the parties to the *status quo ante*. *Brown v. Producers Livestock Loan Co.*, 469 F. Supp. 27, 31 (D. Utah 1978); 5C A. Jacobs, LITIGATION & PRACTICE UNDER RULE *10b-5* § 260.03 [c][vi] at 11-56.

When a "court of competent jurisdiction" enters a final "judgment, decree, or other order" which "determines the basis of property" or "of any transaction on which [the]basis [for valuing an asset] depends" and the basis is different from the basis claimed by a taxpayer, *see* 26 U.S.C. §§ 1312-13, the "effect of the error shall be corrected" despite the restriction otherwise imposed by the statute of limitation. *See* 26 U.S.C. § 1311(a). A

judgment rescinding a purchase of a "tax shelter" and declaring it void "from the inception" would be a determination of a transaction on which the purchaser's basis depended and requires correction of "the effect of the error . . . by an adjustment." *See* 26 U.S.C. § 1311(a).

The IRS may invoke the tax benefit rule. *See* 1 J. Mertens, LAW OF FEDERAL INCOME TAXATION § 7.34 at 7-115 & § 7.37 at 7-129 to -130 (1985) (taxpayer who claims deduction resulting in tax benefit one year and who obtains recovery or repayment in later year must include recovery or repayment as ordinary income in the year of recovery). Invocation of the tax benefit rule " 'eliminates' [a defrauded] purchaser's tax benefits." A. Blankenheimer, *Tax Consequences of Rescission: The Interplay Between Private & Public Law*, 42 U. CHI. L. REV. 562, 588 (1975). If the rule is invoked, "a court ordering recission has no grounds for awarding the seller an offset." *Id.*

E. A Securities Fraud Action Is Not An Appropriate Proceeding In Which To Litigate The Tax Consequences Of An Investment Induced By Fraud.

It is undisputed that Petitioners' investments in Alotel Associates and their recoveries, if any, did and will create tax consequences for them. It is also undisputed that Respondents' sales of limited partnership units and payments of judgments, if any, did and will create tax consequences for them. It is also undisputed that those tax consequences *will* be determined. However, a securities fraud action is not an appropriate proceeding in which to determine those consequences.

A number of factors indicate that a securities fraud trial is not the time to determine tax consequences. First,

the language of section 12(2), of section 10(b) and of Rule 10b-5 does not contemplate making tax adjustments. Second, this Court has indicated that, where a recovery will be subject to taxes, any adjustments should be deferred to the appropriate taxing authorities. *Hanover Shoe, Inc. v. United Shoe Mach. Corp.*, 392 U.S. at 503. Third, the collateral source rule requires that "tax benefits" not be subtracted from recoveries. Finally, the facts necessary to make a proper determination of all tax consequences of the transaction and the resulting recovery can never be known at the time of trial.

It is impossible for a trier of fact to make an accurate allocation because all necessary facts can never be known. The year in which the judgment will finally be collected is unknown. A plaintiff's income and his tax bracket in that year are unknown. A defendant's income and tax bracket in that year are unknown. The tax laws and tax rates in that year are unknown. In the face of all the uncertainty, it is impossible at the time of trial to accurately predict the tax consequences of the fraudulent sale and resulting recovery.

A speculative approximation is, of course, possible. However, it is unnecessary, and it is redundant. Congress intended the IRS and the courts to make the determinations after all the relevant facts were known. When the IRS and the courts do make those determinations, they will make them with precision and in accordance with applicable law.[24] Foisting that responsibility on triers of fact who can never have the necessary facts will yield only speculation.

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[24] No taxing authority can be bound by the result of a securities fraud action to which it is not a party. *See* A. Blankenheimer, *Tax Consequences of Rescission: The Interplay Between Public & Private Law*, 42 U. CHI. L. REV. 562.

The approach that yields mere speculation also adds substantial complexity to already complex securities law cases. The Eighth Circuit held:

> Evidence of [an IRS] audit and expert opinions as to its likely results are admissible at the retrial on damages. Certainly the possibility that past tax deductions will be disallowed is relevant to the determination of the extent of any benefit actually received by plaintiffs from those deductions. The jury is entitled to determine whether and to what extent there would be a disallowance of deductions.

Austin I at 183. Presumably, the jury will also be required to consider and determine the probability and likely outcome of IRS appeals, Tax Court or district court litigation and further judicial review.

Such a procedure creates a dilemma for the defrauded investor. Proving the weakness of his "tax shelter benefits" creates a road map for an IRS audit, but failing to offer proof reduces the damages available. D. Korn, *A Taxing Quandry: Should Investors Deprived of Shelter Sue,* BARRON'S, Jun. 17, 1985, at 39.

Section 12(2) was designed "to provide relatively easy civil relief to [defrauded] purchasers." M. Kaminsky, *An Analysis of Securities Litigation under Section 12(2),* 13 HOUSTON L. REV. at 280. The Eighth Circuit has converted it into a labyrinth.

CONCLUSION

The judgment of the Eighth Circuit should be reversed insofar as it requires "tax benefits" to be con-

strued as "income," which reduces recovery of a defrauded purchaser who rescinds pursuant to section 12(2). The judgment also should be reversed insofar as it requires "tax benefits" to offset damages under section 10(b) and Rule 10b-5. This Court should remand for the entry of judgment awarding Petitioners the consideration paid, interest on the purchase prices from the dates of purchase through the date of judgment and a reasonable attorney's fee.

Respectfully submitted,

ROBERT ARTHUR BRUNIG
O'CONNOR & HANNAN
3800 IDS Tower
80 South Eighth Street
Minneapolis, Minnesota 55402
Telephone: (612) 343-1200

TED S. MEIKLE
FREDRIKSON & BYRON, P.A.
1100 International Centre
900 Second Avenue South
Minneapolis, Minnesota 55402
Telephone: (612) 347-7000

TERENCE M. FRUTH
FRUTH & ANTHONY, P.A.
1350 International Centre
900 Second Avenue South
Minneapolis, Minnesota 55402
Telephone: (612) 349-6969

WILBUR F. DORN, JR.
DORN LAW FIRM, LTD.
300 East Main Street
Anoka, Minnesota 55303
Telephone: (612) 427-5903

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

DR. WILLIAM C. RANDALL, DR. ROGER E. AUSTIN, DR. TOM W. ANDERSON and DR. MYREL A. NEUMANN,

Petitioners,

—v.—

B. J. LOFTSGAARDEN; ALOTEL, INCORPORATED, a Minnesota corporation; PROPERTY DEVELOPMENT AND RESEARCH COMPANY, a Minnesota corporation; and 2361 BUILDING CORPORATION, a Minnesota corporation,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENTS

*John M. Friedman, Jr.
Charles Chasin
DEWEY, BALLANTINE, BUSHBY, PALMER & WOOD
140 Broadway
New York, New York 10005
Telephone: (212) 820-1100
Counsel for Respondents

*Counsel of Record

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QUESTION PRESENTED

In an action under the federal securities laws for fraud committed in the sale of shares in a tax-shelter investment, should the plaintiffs' recovery be reduced by tax benefits realized from the investment?

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STATEMENT OF THE CASE

If it were possible to turn back the clock to 1973, and permit the petitioners truly to rescind their purchases against the respondents, the petitioners would turn over their partnership shares to the respondents, would get back their purchase price from the respondents, and would never receive tax benefits. The respondents would thereby acquire the shares and become entitled to the associated tax benefits.

The clock cannot be turned back. But the economic equivalent of turning it back can be attained, and was attained by the Eighth Circuit. The petitioners, who received in permanent tax benefits nearly as much as they invested, were awarded the difference.

Having been made whole, the petitioners now seek a measure of damages that would allow them to recover their investment in its entirety and keep all their tax benefits as well. Nothing in the securities laws permits this. The petitioners do not seek to remedy an injustice, but to create one. They seek a windfall for themselves and a penalty or forfeiture for the respondents.

The Petitioners' Investment

In 1973, the petitioners each decided to invest in a tax shelter, Alotel Associates, requiring that they have a net worth in excess of $200,000 or be in the 50% income tax bracket. (J.A. 157; P1. Ex. 2; Tr. 42). Each petitioner bought one "unit," or limited partnership share, for $35,000 except Dr. Neumann, who bought 1 1/2 units for $52,500. (J.A. 16, 35, 36). Alotel Associates was to apply the funds raised from the sale of these units, and from other sources, to build a Ramada Inn motel and to yield substantial tax benefits to the investors.

As with any tax shelter, tax benefits were a central consideration in the marketing and sale of the units. For example, as it

was originally marketed, Alotel Associates offered fewer tax benefits; in that form, it was unable to sell enough units to proceed (Tr. 109-11, 273, 647-48); a revised version of its program, for the same motel, but with enhanced tax benefits, had to be developed before enough investors were interested. (Tr. 647-48).

The Offering Memorandum for the units reveals plainly that the petitioners and the respondents understood that tax benefits were an important part of the return on any investment in Alotel Associates. Thus, the Offering Memorandum stated that Alotel Associates "is intended to operate as a 'tax shelter' and will lead to significantly greater returns for persons in relatively high income tax brackets; correspondingly returns will not be as great for those not in high income tax brackets. . . ." (J.A. 93; Pl. Ex. 2; Tr. 42). The investors were cautioned that pending Administration tax proposals could "eliminate the forecasted income tax savings for the years 1973 through 1976. . . ." (J.A. 106; Pl. Ex. 2; Tr. 42).

At trial, an expert for the defendants noted the importance of these tax savings as reducing the effective capital investment of each limited partner. (J.A. 183-85).

Included in the Offering Memorandum were various financial statements prepared by the accounting firm of Touche Ross & Co. The financial statements displayed projected operating results, and reflected projected tax savings per $35,000 unit on the assumption that the investor had a combined federal and Minnesota tax rate of 54%. (J.A. 116-17; Pl. Ex. 2; Tr. 42).[1]

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1 At a 54% combined federal and state tax rate, an investor is better off with a dollar of tax deductions than with a dollar of taxable income. A dollar of taxable income would leave 46 cents after taxes. A dollar of deductions would be worth 54 cents by reducing one's tax bill in that amount. This is why it is sometimes more important for tax shelters to provide paper losses for deductions than to provide taxable dollars to the investors. It also shows that such deductions are a genuine form of return on the investment—indeed, they can be more valuable than a return in dollars.

Equally important was an attorneys' opinion in the Offering Memorandum that Alotel Associates would be treated as a partnership for tax purposes (J.A. 111-12; Pl. Ex. 2; Tr. 42); without such treatment, there would be no pass-through of tax savings to the investors.

Laced throughout the Offering Memorandum were descriptions of various matters governing the tax consequences to the investors. (*See*, *e.g.*, J.A. 102-04, 106; Pl. Ex. 2; Tr. 42) (the allocation of profits and losses; the recapture of depreciation by Alotel Associates; the treatment of Alotel Associates as a dealer in real estate; the use of accelerated depreciation; the effect of pending legislation; and the attorneys' opinion and financial projections referred to above). Nearly every one of the 17 detailed notes to the financial statements had direct bearing on the estimated tax savings that an investment in Alotel Associates would yield. (*See* J.A. 120-29; Pl. Ex. 2; Tr. 42).

All profits and losses were allocated to the limited partners (J.A. 102-03; Pl. Ex. 2; Tr. 42), with the general partners taking a fee. This permitted deductible payments by Alotel Associates to the general partners, providing tax benefits to the investors above and beyond what would arise from the general partners' taking a share in the profits and losses.

To ensure that the investors obtained the tax benefits they expected, Alotel Associates, through the respondents, took a number of steps. Alotel Associates borrowed over $2.5 million, an amount approximately three times the amount invested by the limited partners. Borrowed funds increased each limited partner's basis and thereby increased the amount of deductible losses a partner could take. The borrowings were arranged exclusively by the respondents for Alotel Associates. Yet, the tax benefits flowing from Alotel Associates' use of the borrowed funds went directly to the petitioners as partners in Alotel Associates.

In addition, the general partners had to spend funds as required by the Internal Revenue Code to bring about the expected tax savings: a motel had to be built; franchise fees had to be paid; furniture had to be purchased; fixtures and other equipment had to be bought and installed; paving and landscaping had to be arranged; mortgage payments had to be made; insurance had to be secured; and so forth. (*See* J.A. 118; Pl. Ex. 2; Tr. 42). To the extent these and other expenditures did not come about, or came about in a different pattern, or even came about later rather than earlier, the value of the tax benefits arising from an investment in Alotel Associates would be altered substantially.

Subsequent Events

The motel began operating in June of 1974. (Tr. 670). After disputes arose, Loftsgaarden withdrew as general partner of Alotel Associates in September of 1975.

Both before and after Loftsgaarden withdrew as general partner, the petitioners and other investors lent funds to Alotel Associates, even after the misrepresentations in the Offering Memorandum were discovered. (*See* Tr. 466, 568, 591).[2]

In August-September 1975, when the petitioners discovered or should have discovered the fraud,[3] the petitioners made a conscious election to retain their investment. They could have tendered their shares to the respondents in 1975, but the result of a tender at that time would have been the loss of thousands of dollars in tax benefits. Instead, the petitioners chose to retain their shares.

In 1977, the mortgage lender foreclosed on the motel. *See United Realty Trust v. Property Development and Research*

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2 The jury found that in making the loans the petitioners no longer relied on the misstatements in the Offering Memorandum. (J.A. 81).

3 *See* Pet. App. E-13, Findings of Fact, Conclusions of Law and Order for Judgment by Judge Larson, dated August 15, 1980.

Co., 269 N.W.2d 737 (Minn. 1978). The foreclosure resulted in the reversal of some, but far from all, of the tax benefits the petitioners had received from their investment. In the case of Dr. Austin, for example, without the foreclosure his total tax benefits would have been $59,607 on a $35,000 investment. The foreclosure reduced the aggregate tax benefits to $33,333. The petitioners have since been audited by the Internal Revenue Service. The relevant tax years are closed. Their remaining tax benefits are now permanent. *See Austin II*, 768 F.2d at 955. Those benefits are listed below:

	Investment	*Permanent Tax Benefits*
Randall	$35,000	$36,404
Austin	35,000	33,333
Anderson	35,000	29,615
Neumann	52,500	57,014

(J.A. 211).

Institution of Suit

In 1976, the petitioners sued Alotel Associates' two general partners and other individuals and corporations,[4] asserting that statements made by them to induce the purchase of the units were false and misleading. (J.A. 11-16, 33-35). Originally, no claim was made under Section 12(2) of the 1933 Act; damages were sought under Section 10(b) of the 1934 Act. Complaint of February 24, 1976. Subsequently, a Section 12(2) claim was added and the petitioners tendered their shares pursuant to that provision in 1980, shortly before trial, after there were no more tax benefits to be obtained from ownership of the units.

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4 B.J. Loftsgaarden was one of the general partners of Alotel Associates. Alotel, Incorporated was the other general partner. Property Development and Research Company ("PDRC") was to obtain the real estate required in the venture. 2361 Building Corporation ("2361 Corp.") was the project's general contractor. *See Austin I*, 675 F.2d at 173 & n.4. Loftsgaarden was the sole shareholder of the corporate defendants. *Id.* at 173. (Unless the context indicates otherwise, "the respondents" hereinafter refers to the general partners, Loftsgaarden and Alotel, Incorporated.)

The jury found that the respondents had made untrue statements or omitted to state material facts in violation of Section 12(2) of the 1933 Act and Section 10(b) of the 1934 Act. (J.A. 79, 82, 84, 86). The issue before the Court relates solely to the measure of damages under these statutes.

There is no issue before the Court as to the respondents' liability, nor is there any issue whether the respondents were "unjustly enriched" from the petitioners' funds, despite the petitioners' repeated contentions to the contrary throughout their brief. The Eighth Circuit expressly found in *Austin II*, "it does not appear that the defendant has 'retained' any of plaintiffs' consideration; rather these monies were paid to the partnership and were invested in the project." 768 F.2d at 956.[5]

Based on the foregoing and related facts, the Eighth Circuit and trial court determined that:

> (a) tax benefits were at the heart of this investment which was marketed and sold as a tax shelter (*Austin I*, 675 F.2d at 182-83);
>
> (b) the amount of anticipated tax benefits affected the desirability of the investment, or the price the investors would pay (*Id.* at 174);
>
> (c) the tax benefits were achieved through the respondents' application of Alotel Associates' funds, including, predominantly, borrowed funds raised by the respondents (*Id.* at 173-74);
>
> (d) the tax deductions and credits giving rise to the benefits were generated by Alotel Associates and passed through to the petitioners because Alotel Associates was

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5 Moreover, at trial, the petitioners specifically dropped claims that Loftsgaarden and Alotel, Incorporated breached fiduciary duties owed to the limited partners (Tr. 730), even though those claims related to alleged improper profits made by Loftsgaarden's controlled corporations, improper cost allocations, mismanagement and usurpations of partnership business opportunities. (J.A. 22-24, 43-45). These are the very bases of the petitioners' "unjust-enrichment" theories here. This issue is a red herring, which we treat in IV.G., *infra*.

set up and maintained as a partnership for tax purposes (*Id.*);

(e) the petitioners received the tax benefits (*Austin II*, 768 F.2d at 955);

(f) the tax benefits were of value (*Id.*); and

(g) the tax benefits are now permanent (*Id.*).

SUMMARY OF THE ARGUMENT

Tax shelters provide genuine economic returns to investors in the form of tax benefits. Tax shelter investors consider their tax benefits to be part of the return on their investment, and the availability of such benefits is at the heart of the investment decision. Indeed, the SEC's and others' definitions of a tax shelter turn on how material the tax benefits are to an investment decision. The motel tax shelter involved in this case could not be marketed successfully until the tax benefits it contemplated were increased; without such an increase, investors were not interested in investing in the motel. (Point I.)

Damages under Rule 10b-5 are to compensate investors for their net economic loss and return them to the *status quo ante*. This is required by the statutory limitation on a damage recovery to actual damages, a limit which has been consistently applied. One way to accomplish this is through rescissionary damages, or other forms of relief, all designed to put the parties back in the economic positions they were in before the events. Here, subtraction of tax benefits is necessary lest the petitioners receive a windfall and the respondents be subjected to an unfair penalty, results which are inconsistent with the statutory limitation. (Point II.A.)

While the petitioners argue that the tax benefits were "collateral" to the investment, the opposite is true. With fewer tax benefits contemplated, the motel project could not attract sufficient investors. It was only through the partnership and the respondents' efforts that the petitioners were able to obtain

the tax benefits. The fact that the benefits were ultimately conferred by the Government does not mean they were collateral, any more than it would if the partnership distributed promissory notes to the limited partners and they obtained payment on the notes from the payors. (Point II.B.)

The rescissionary measure of damages under Section 12(2) of the 1933 Act must be read *in pari materia* with the "actual damages" limitation of the 1934 Act, lest the penalty for negligence, the Section 12(2) standard, exceed that for scienter, required under Rule 10b-5. The courts have generally read the statutes *in pari materia* for this and related reasons. (Point II.C.1.)

Turning to the language of Section 12(2), we agree with the Government that the provisions must be read in the light of the common law of restitution. These principles support the lower court. At common law, the plaintiff had to return everything of value he had received in the transaction, or subtract that value from the damage award, which amounts to the same thing. The term "income received" in the statute should be understood as the lower court read it, to mean value received, the meaning consistent with the common law origin of the remedy. A different interpretation ignores economic reality. (Point II.C.2.)

The lower court correctly applied interest to the net amount the petitioners were out of pocket in each year. The petitioners do not contest this treatment under Rule 10b-5, but argue that it is inappropriate under Section 12(2) because of the location of the word "interest" in the statute, after the term "consideration paid" and before the term "income received." Viewing tax benefits as reducing the net investment, or "consideration paid," avoids the petitioners' argument, and is consistent with both sides' expert testimony. Apart from this, nothing in the statute prevents a court in its discretion from imputing interest on the "income received," all to the same effect. The petitioners' approach creates a windfall for them by compensating them for more than their damages, and a penalty to the

respondents. Such an interpretation should be avoided. (Point II.D.)

We ask the Court to correct, under the "plain error" rule (U.S. Sup. Ct. Rule 34.1(a)), the lower court's doubling the interest portion of the award; there is no objection to its having doubled the damage portion. Unlike the damage portion of the award, which is taxable precisely because of the recognition of earlier tax benefits, the taxability of interest as ordinary income has nothing to do with the tax benefits conferred here. The purpose of interest is to compensate for income lost; to award the petitioners what amounts to after-tax interest treats them more favorably than other investors under the securities laws for no reason. (Point III.)

In Point IV., we briefly treat the petitioners' miscellaneous other arguments.

ARGUMENT

I. Tax Benefits Created And Distributed By Tax Shelters Are A Return On An Investment

Taxes are an inevitable part of our economic lives. An industry has grown up to marshall and sell tax savings through tax shelters. These shelters have as many forms as there are governmental incentives to economic activity administered through the tax laws. *See generally* R. Haft & P. Fass, *1985 Tax Sheltered Investments Handbook* (1985) (examining real estate, oil and gas, equipment leasing, farming and other tax shelters).

Tax shelters provide benefits in a variety of ways to investors. Relevant here are tax credits, depreciation, deferrals, and leveraging.

Tax credits are provided for certain expenditures the government encourages, most notably purchases qualifying for the investment tax credit.[6] Investors are entitled to deduct from

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6 26 U.S.C. § 46.

their tax bills, as a credit, a percentage of every dollar a motel tax shelter like Alotel Associates spends on items such as television sets and refrigeration equipment.

Although most business expenses are deductible, depreciation deductions were among the largest involved here. Alotel Associates was authorized under the tax laws to depreciate its property over a shorter time than its actual life,[7] resulting in greater deductions for the investors than would have been available without accelerated depreciation.

Tax deferrals are also important to investors. Because of the time value of money, it is valuable to be able to defer a tax payment from a given year into the future. Because deferrals do not alter one's aggregate tax liability, the petitioners have argued that some or all of the tax benefits here were illusory. This misses the point. A deduction of a dollar in year one is still valuable even though it may result in a recapture of a dollar of income in year ten. Here, the largest item of deferral arose from accelerated depreciation, where some, but not all, of the early deductions were recaptured in later years.

Leveraging is one of the most important tools in tax shelter investments. Alotel Associates, for example, borrowed three times what the investors put up as their investments; yet, the various deductions and credits arising from appropriate expenditures all went to the investors, even if the borrowed funds were used for those expenditures. This had a multiplier effect on the amount of tax benefits available to the petitioners from their investment.

Tax shelters serve a vital role in attracting capital to investments that would not be made without a form of governmental subsidy. Thus, a book introducing investors to tax shelters states that tax shelters:

> result from a conscious decision on the part of Congress that various key industries, vital to the economy, can best

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7 26 U.S.C. § 167.

> be financed by attracting capital through the technique of granting tax incentives for such investment, rather than by supporting such industries through direct government subsidies or government owned and operated companies.
>
> . . . .
>
> The Congressional decision to encourage investment in various critical industries also reflects the fact that the historic return on dollars invested in such industries is not high enough to attract sufficient capital to the industry without the encouragement of the tax incentives.

L. Mosburg, *Tax Shelter Desk Book* 1-2 (1978).

The critical feature of tax shelters is the use of tax benefits to enhance the return on investments the Government seeks to encourage. Thus, in considering a tax shelter, an investor evaluates his tax benefits along with the other aspects of his return:

> Return from a tax sheltered investment will consist of cash flow, tax benefits and appreciation equity value. The three elements of return are normally interdependent. . . . Generally however, if tax benefits are increased, such increase will be at the expenses of cash flow and the appreciation potential. If either cash flow or appreciation potential are enhanced, such enhancement may be at the expense of the other return component.
>
> Since all three items of return are relevant, no method of analysing the rate of return on the investment should fail to take into account all of the components.

R. Haft & P. Fass, 4 *Tax Sheltered Investments*, Intro. 8-9 (3rd ed. 1981).

In many cases, the initial beneficiary of these tax benefits is a form of business organization that engages in the type of activity sought to be fostered. If the entity is a corporation, it uses the tax benefits to reduce its own tax obligation. In some circumstances, the corporation can transfer or even sell these

tax benefits if, for example, through a lack of taxable income, it cannot use the tax benefits itself.[8] In the hands of the transferee, the tax benefits are the functional equivalent of vouchers with which to pay taxes.

When the business organization is a partnership meeting certain tests under the Internal Revenue Code, the tax benefits are distributed among the partners by operation of the tax laws; the partnership is transparent for tax purposes. *See* 26 U.S.C. § 701 *et seq*. If a partner transfers his partnership share, future tax benefits accrue to the new owner because the right to the tax benefits, like the right to returns from investments generally, is an incident of ownership.

The very definition of a tax shelter therefore turns on how material this pass-through of tax benefits is to the investor. The Securities and Exchange Commission, for example, defines a tax shelter as:

> an investment in which flow-through tax benefits are a material factor affording investors relatively large deductions and lower income tax rates.

SEC Release No. 34-10260 [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,417, at 83,192 n.2 (July 2, 1973).

Similarly, the American Bar Association Committee on Ethics and Professional Responsibility defines a tax shelter as:

> [a]n investment which has as a significant feature for federal income or excise tax purposes either or both of the following attributes: (1) deductions in excess of income from the investment being available in any year to reduce income from other sources in that year, and (2) credits in excess of the tax attributable to the income from the investment being available in any year to offset taxes on income from other sources in that year.

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8 *See, e.g.*, 26 U.S.C. § 168(f)(8) (permitting so-called safe harbor leases); § 382 (permitting transfers of tax losses in specified circumstances).

ABA Comm. on Ethics and Professional Responsibility, Revised Formal Op. 346, n.1 (1982) (tax shelters).

The investor's perception of tax benefits as a return on his investment is no more manifest than in litigation spawned by tax benefits gone awry. Disappointed investors in tax shelters have sued those who have undertaken, but failed, to supply various forms of tax benefits. *E.g.*, *Lasker v. Bear, Stearns & Co.*, 757 F.2d 15, 16-17 (2d Cir. 1985) (fraud and breach of contract for ineffective tax straddles); *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 190-91 (3rd Cir. 1981) (alleged fraud as to existence of tax benefits), *cert. denied*, 455 U.S. 938 (1982).

Alotel Associates described itself as a tax shelter and was marketed and sold as such. The Offering Memorandum was rife with descriptions of the tax benefits from the investment as well as what might impair them. Indeed, if Alotel Associates' units were being offered to the public today, the Securities and Exchange Commission's Rules would require substantial disclosures as to tax benefits (and risks relating to them) precisely because they are material—if not central—to an investment decision:

> In a registration statement for a limited partnership, it is generally the case that tax consequences of an investment are material and thus are discussed in the prospectus. This derives in part from the Commission's specific guidance as to disclosure of tax matters in offerings involving real estate limited partnerships. See, Guide 5 of the Securities Act Industry Guides.

Hopper, Kanouff, Smith & Peryam (SEC Staff Interpretative Letter) (available October 11, 1982).[9]

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9 Industry Guide No. 5, Preparation of Registration Statements Relating to Interests in Real Estate Limited Partnerships, requires inclusion of opinions on a variety of tax issues relating to limited partnerships, with an emphasis on the risks that anticipated tax benefits will be lost through failure to meet formal requirements or through economic events. Fed. Sec. L. Rep. (CCH) ¶ 3829 at 3338-39, 3342-45 (May 24, 1982).

Both the Eighth and Second Circuits have recognized the economic reality of tax benefits produced by tax shelters. *Austin II*, 768 F.2d at 955 (plaintiffs' tax benefits are "economic benefits bargained for and received"); *Salcer v. Envicon Equities Corp.*, 744 F.2d 935, 940 (2d Cir. 1984) ("tax benefits to the partner represent an important tangible economic advantage expected to be derived from his investment"), *pet. for cert. filed*, 53 U.S.L.W. 3688 (U.S. Mar. 13, 1985) (No. 84-1447) (hereinafter "*Salcer*").

For this reason, many courts have agreed with or anticipated the decisions of the Eighth and Second Circuits. In *Bridgen v. Scott*, 456 F. Supp. 1048 (S.D. Tex. 1978), a Rule 10b-5 case brought by limited partners in a real estate tax shelter investment, the court said:

> Requiring the jury or this Court to try this case without reference to the tax consequences of the transaction would be requiring the jury and the Court to live in an artificial "never-never land." The plaintiffs' position that the tax consequences of this transaction should be ignored is simply not realistic and is tantamount to requesting this Court and the jury to try this case blindfolded.

Id. at 1061.[10] The *Bridgen* Court relied in large part on the Fifth Circuit's holding in *Dupuy v. Dupuy*, 551 F.2d 1005,

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10 *See Herber v. Omega Oil Corp.*, No. 85-C-384, slip op. at 17 (N.D. Ill. Nov. 1, 1985) (plaintiff's "recovery in a rescissionary remedy should probably be reduced by any 'tax shelter' or other benefit he reeeived as a result of his investment") (available on LEXIS, Genfed library, Dist file); *Feldman v. Pioneer Petroleum, Inc.*, 606 F. Supp. 916, 923 (W.D. Okla. 1985) (tax benefits must be considered in evaluating the actual damages suffered); *Smith v. Bader*, 83 F.R.D. 437, 439 (S.D.N.Y. 1979) ("knowledge of plaintiffs' income tax rate and the net value of their investment, along with other information, may be needed to calculate any tax benefits which may mitigate damages"); *Berg v. Xerxes-Southdale Office Bldg. Co.*, 290 N.W.2d 612, 615 (Minn. 1980) (no damages if, "because of income tax considerations, . . . the selling price equaled the market value of the property").

1025 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977), that the district court did not abuse its discretion in considering tax benefits in a fraud action under the securities laws.

These decisions demonstrate judicial recognition of an economic fact—that tax benefits "represent an important tangible economic advantage expected to be derived" from a tax shelter investment. *Salcer*, 744 F.2d at 940.

The petitioners do not quarrel with this, but argue that the respondents seek a "treatment" for tax shelters that "differs" from that for other investments, and that the securities laws do not authorize such a distinction. Brief for Petitioners at 13-16.

The respondents seek only recognition that the law of damages requires subtraction of value bargained for and received on an investment. For tax shelters, at least as defined by the SEC and others, that value is in the form of tax benefits.[11]

II. Damage Awards Under The Securities Laws Are Reduced By Returns On The Investment, Including Tax Benefits From Tax Shelters

A. *Tax Benefits Must Be Subtracted Under Rule 10b-5*

Under Rule 10b-5, the petitioners are entitled to be restored to the *status quo ante* and no more. That result has been accomplished by starting with their investment and subtracting the value of the tax benefits they received—a rescissionary measure of damages. *Austin II*, 768 F.2d at 953-54.

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11 To the extent the petitioners cite tax shelter securities cases that may be read as differing with the Eighth and Second Circuits, such cases, at best, only express the conflict in the lower courts; they do not aid in resolving it. *See, e.g.*, Brief for Petitioners at 27-29. The other cases the petitioners rely on do not involve the kind of tax benefits flowing from the ownership of an investment as contemplated by tax shelters. They deal instead with such matters as the tax consequences of a disposition of the investment—consequences that were not part of the securities offering or the investment decision and were not part of the value bargained for and received.

Other methods of restoring a plaintiff to the *status quo ante* are widely used,[12] most commonly the out of pocket rule, which in the case of a defrauded buyer measures the difference in value between what he paid and what the securities were actually worth.[13]

Restoring a plaintiff to the *status quo ante* in cases such as this is based on the "actual damages" limitation in Section 28(a) of the 1934 Act, which provides:

> . . . no person permitted to maintain a suit for damages under the provisions of [the 1934 Act] shall recover,

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12 *See* 5C A. Jacobs, *Litigation and Practice Under Rule 10b-5* § 260.03[c][ii]-[vi] at 11-27 to 11-87 (2d ed. 1985) (measures of damages include: out of pocket, resale or "*Chasins*," cover, benefit of the bargain, and rescissional or restitutional damages); L. Loss, *Fundamentals of Securities Regulation* 1132-39 (1983) (general rule is out of pocket measure qualified by eight "voracious" exceptions to the rule).

13 The petitioners paid the amount of their investment and got shares whose only value, as it happened, was from tax benefits. An out of pocket measure of damages accordingly would produce the same subtraction as the rescissionary measure used here. Although in a different context, Judge Larson correctly ruled, "[i]n this case, however, an out-of-pocket or a rescissionary measure would yield the same results." Pet. App. F-7, Memorandum Order by Judge Larson, dated August 15, 1980. *See generally* 5C A. Jacobs, *Litigation and Practice Under Rule 10b-5* § 260.03[c][vi][B] at 11-83 (2d ed. 1985) (out of pocket measure theoretically equivalent to rescissionary damages where plaintiff buys security for cash).

The cases where rescissionary damages would produce a different outcome from the out of pocket rule are not relevant here. They are (a) where the security has appreciated in the hands of a defrauded buyer, or (b) where it has lost its value after being sold by a defrauded seller. In both cases it would be unusual to find the defrauded person suing.

The final permutation is (c) the defrauded seller whose stock appreciates in the hands of the fraudulent buyer; here rescission helps the plaintiff seller more than a strict out of pocket rule, and is usually justified on the basis of "unjust enrichment" arising from the security's appreciation in the hands of the fraudulent buyer. This was the case in *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 155 (1972), relied on by the petitioners as supporting their claim for a recovery beyond their actual damages.

> through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of.

Thus, the Second Circuit, in the light of Section 28(a), has characterized the rescissionary measure of damages as follows:

> The rescission theory of damages which we essentially utilize here cannot restore a plaintiff to a *better* position than he would have been in if the fraud had not occurred.

Rolf v. Blyth, Eastman Dillon & Co., Inc., 570 F.2d 38, 49 n.22 (2d Cir.) (emphasis in original), *cert. denied*, 439 U.S. 1039 (1978).[14] In this respect, the limitation to "actual damages" parallels the common law rule for actions in deceit:

> [The aim of compensation] would seem to direct the courts in giving damages for deceit, to resort to a similar measure to that used in cases of rescission, and to try to place the plaintiff, as nearly as possible, financially on a par with his position before he was defrauded. In other words, the plaintiff would recover the value of what he has parted with under the fraudulent inducement, less the value of what he got under the bargain.

C. McCormick, *Handbook on the Law of Damages* § 121 at 449 (1935).[15]

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14 *See also Clark v. John Lamula Investors, Inc.*, 583 F.2d 594, 604 (2d Cir. 1978) ("total rescission damages are the difference between the price she paid and the price she received for the debentures . . . plus such accrued interest as she may have been required to pay at the time of purchase, less such interest as she may have received during the period she held the securities"); *Richardson v. MacArthur*, 451 F.2d 35, 43 (10th Cir. 1971) (buyer's recovery reduced by " 'dividends or any other payments received from the defendant seller' ").

15 *See generally Smith v. Bolles*, 132 U.S. 125, 129-30 (1889) (stating the pre-*Erie* federal common law). The common law doctrines of rescission and restitution are treated more fully in II.C.2., *infra* (dealing with Section 12(2) of the 1933 Act).

Under these principles, it is logical that the courts have uniformly prohibited an award of punitive damages under Rule 10b-5.[16] For the same reasons, the courts have also ruled that Section 28(a) precludes an award of attorneys' fees.[17] Section 28(a) and Rule 10b-5 have been interpreted in this way at least since *Estate Counseling Service, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 303 F.2d 527, 533 (10th Cir. 1962) (out of pocket limitation applied to defrauded buyer). Congress has not acted to alter this, although the securities laws have been amended many times over the years, and Section 28(a) itself was amended in 1982 with no change in the "actual damages" language. *See* Act of October 13, 1982, Pub. L. No. 97-303, Sec. 4, 1982 U.S. Code Cong. & Ad. News (96 Stat.) 1409. Under analogous circumstances this Court remarked:

> In 1975 Congress enacted the "most substantial and significant revision of this country's Federal securities laws since the passage of the Securities Exchange Act in 1934." . . . When Congress acted, federal courts had consistently and routinely permitted a plaintiff to proceed under § 10(b) even where express remedies under § 11 or other provisions were available. In light of this well-

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16 *See, e.g., Huddleston v. Herman & MacLean*, 640 F.2d 534, 559 n.46 (5th Cir. 1981) (Unit A) (Section 28(a) precludes recovery of punitive damages), *aff'd in part and rev'd in part on other grounds*, 459 U.S. 375 (1983); *Byrnes v. Faulkner, Dawkins & Sullivan*, 550 F.2d 1303, 1313 (2d Cir. 1977) (on its face Section 28(a) precludes recovery of punitive damages); *Straub v. Vaisman and Co., Inc.*, 540 F.2d 591, 599 (3rd Cir 1976) (prohibition on recovery in excess of actual damages bars recovery of punitive damages); *see also* 5C A. Jacobs, *Litigation and Practice Under Rule 10b-5* § 260.03[e] at 11-131 to 11-132 (2d ed. 1985) ("all [authorities] concur that the words 'actual damages' preclude punitive damages"); L. Loss, *Fundamentals of Securities Regulation* 1139 (1983) ("[I]t is clear that punitive or exemplary damages are precluded by the limitation in § 28(a) to 'actual damages.' ")

17 *See, e.g., Woods v. Barnett Bank of Fort Lauderdale*, 765 F.2d 1004, 1014 (11th Cir. 1985); *Huddleston*, 640 F.2d at 559; *Straub*, 540 F.2d at 599.

> established judicial interpretation, Congress' decision to leave § 10(b) intact suggests that Congress ratified the cumulative nature of the § 10(b) action. *See Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353, 381-382 (1982); *Lorillard v. Pons*, 434 U.S. 575, 580-581 (1978).

Herman & MacLean v. Huddleston, 459 U.S. 375, 384-86 (1983) (footnotes omitted).

Applying the general rules of rescissionary damages under Rule 10b-5 to the present case, the central question is what would it take to return the petitioners to the *status quo ante*. Putting aside the issue of interest for a moment, the answer is: just what the Eighth Circuit gave them. In view of the permanence of the petitioners' tax benefits, any greater recovery than that permitted by the Eighth Circuit would, in conflict with Section 28(a), produce a windfall for the petitioners and a forfeiture or penalty for the respondents.

The petitioners, citing *Osofsky v. Zipf*, 645 F.2d 107, 111 (2d Cir. 1981), contend that the "actual damages" provision was "meant only to prevent duplicative recoveries when a plaintiff asserted a state law claim as well as a federal securities law claim." Brief for Petitioners at 23. This is a distortion of *Osofsky*. The petitioners' interpretation omits language from *Osofsky* that, in addition to prohibiting a duplicative recovery, Section 28(a) also prohibits awards of punitive, as opposed to compensatory, damages. *See Osofsky*, 645 F.2d at 111.[18] And,

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18 The petitioners also cite cases and statutes defining the phrase "actual damages" as used in patent, copyright, and trademark law. The petitioners quote from the Court's opinion in *Birdsall v. Coolidge*, 93 U.S. 64, 64 (1876), defining "actual damages" as used in a patent statute. In *Birdsall*, the Court stated that "[c]ompensatory damages and actual damages mean the same thing; that is, that the . . . amount awarded shall be precisely commensurate with the injury suffered, neither more nor less. . . ." *Id.*

To the extent the petitioners' authorities discuss tax consequences, they are totally inapposite. *See L.P. Larson, Jr., Co. v. Wm. Wrigley, Jr., Co.*, 277 U.S. 97 (1928) (infringer of competitor's gum packaging denied subtraction

of course, the Second Circuit was well aware of its decision in *Osofsky* when it decided *Salcer* directly contrary to the petitioners' position. *Salcer*, 744 F.2d at 939-40 (citing *Osofsky*).

The Government, on the other hand, would have the courts rely on the tax code to prevent windfalls, as if, should this Court increase the petitioners' award, the Internal Revenue Service would confiscate the entire increase:

> [T]he Internal Revenue Code incorporates sophisticated mechanisms for preventing undeserved windfalls to taxpayers in circumstances like those here. Those mechanisms, unaided by the court of appeals' tinkering, will achieve the result that the court of appeals desired, and will do so in the manner that Congress has ordained.

Brief for Government at 23.

This is nonsense. The petitioners would not be here if the Government was going to take away any increase in the award they hope to achieve.[19] Even if this were true, there is simply

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of income taxes paid); *Wolfe v. National Lead Co.*, 272 F.2d 867 (9th Cir. 1959) (trademark infringer not permitted to subtract income taxes paid), *cert. denied*, 362 U.S. 950 (1960); *Alfred Bell & Co. v. Catalda Fine Arts, Inc.*, 191 F.2d 99 (2d Cir. 1951) (copyright infringer not permitted to subtract income taxes paid); *Sheldon v. Metro-Goldwyn Pictures Corp.*, 106 F.2d 45 (2d Cir. 1939) (copyright infringer prohibited from subtracting income taxes paid), *aff'd*, 309 U.S. 390 (1940); *Goodyear Tire & Rubber Co. v. Overman Cushion Tire Co.*, 95 F.2d 978 (6th Cir. 1938) (patent infringer prohibited from subtracting income taxes paid), *cert. dismissed*, 306 U.S. 665 (1939); *Carter Products, Inc. v. Colgate-Palmolive Co.*, 214 F. Supp. 383 (D. Md. 1963) (patent infringer and trade secret misappropriator prohibited from subtracting income taxes paid). As a general matter, damage payments by the defendants in these cases would be income to the patentee. *See Carter Products*, 214 F. Supp. at 406 (patent and trade secret holder would be required to pay income taxes on amount recovered). In this respect, the cases resemble the authorities we treat in IV.A., *infra*, and are distinguishable on the same grounds.

19 *See Austin II*, 768 F.2d at 955 (petitioners' tax benefits are permanent and cannot be recouped by the Government); *see also* IV.B., *infra*.

no need for it; the petitioners are whole now. What point would be served by having the respondents pay more simply to benefit the Treasury? Such a payment would constitute the very sort of penalty that Section 28(a) prohibits, since the tax credits and deductions were proper under the Internal Revenue Code and the petitioners already have been made whole.

B. *The Collateral Source Rule Does Not Apply*

The principal reason the petitioners give for neglecting the tax benefits—plainly of economic value to them—is that the benefits came from the Government and not from their investment,[20] and that the collateral source rule bars consideration of benefits received from a third party in determining the extent of the respondents' liability. Brief for Petitioners at 29-31. This confuses the entity which ultimately confers the benefit (in this case, the Government) with the entity which, itself having the right to the benefit (Alotel Associates), transferred that right to the petitioners.[21]

The collateral source rule:

> prohibits taking into consideration benefits received from third parties as the result of wholly separate and distinct transactions, such as those received under insurance policies negotiated independently. Restatement (Second) of Torts § 920A(2) (1979). A classic example is the court's ruling in a personal injury action that a plaintiff's recov-

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20 We assume that the petitioners do not argue that there is to be a different result if some benefit came from their investment rather than from those they chose to sue. Such a position would be illogical since the receipt of the benefits is one of the consequences of a fraudulently induced investment, and such a position would deny an offset even in the case of cash dividends.

21 The petitioners received tax benefits in this case because the real estate venture was set up as a partnership, and all deductions and tax credits passed through to the partners. 26 U.S.C. § 702. If the venture had instead been set up as a corporation, then the respondents' same efforts would have resulted in tax deductions and credits for the corporation rather than for the petitioners.

> ery is not to be reduced by any insurance proceeds received under his independent insurance policy in which the defendant played no part.
>
> The essence of the collateral source rule is the independence of the transaction giving rise to the collateral source, such as the insurance policy.

Salcer, 744 F.2d at 941.

In this case, Alotel Associates received $157,500 from the petitioners and borrowed over $2 million. The respondents used these funds to purchase property, to do paving and landscaping, to buy fixtures and furniture, and so on—in short, to build a multi-million dollar motel. Only by virtue of the respondents' efforts to build a motel in accordance with the tax code criteria were tax benefits created. Because of the form of the venture, organized and maintained as a partnership for tax purposes, these tax benefits passed through to the petitioners. To characterize the respondents' efforts as "collateral" to the petitioners' receipt of tax benefits ignores reality.[22] Nothing emphasizes this so much as the respondents' securing loans for Alotel Associates. The respondents obtained these funds exclusively through their own efforts; Alotel Associates' expenditure of these funds, amounting to some three times what the investors advanced, resulted in three times more tax benefits than the investors would have received without the respondents' having secured the loans. Thus, the respondents not only saw to the proper expenditure of the petitioners' funds, but acquired and spent borrowed funds to greatly

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22 That the tax benefits are not collateral is further evident when one considers that the respondents could have been liable to the petitioners for damages had the respondents been unable to secure tax benefits for them. *See Sharp v. Coopers & Lybrand*, 649 F.2d 175, 190-91 (3rd Cir. 1981) (absence of represented tax benefits is one component of fraud), *cert. denied*, 455 U.S. 938 (1982); *Beggs v. Dougherty Overseas, Inc.*, 287 F.2d 80, 83 (2d Cir. 1961) (where tax benefits were considered by parties when they entered into employment contract, lost tax benefits were allowed as damages in wrongful discharge action).

enhance the benefits the petitioners received. As the Second Circuit stated in *Salcer*:

> the tax benefits, although paid by the government, emanate directly from the tax shelter sought by the plaintiffs and provided by defendants, without which plaintiffs could not have realized any tax benefits. Benefits resulting directly from a transaction under attack must be credited toward the damage award.

744 F.2d at 941-42.[23]

The petitioners assert that a defendant could always argue that a collateral source payment results "directly" from his efforts in the sense that but for his tortious conduct there would have been no payment. The petitioners argue that the inquiry should therefore be simply "whether the benefit is conferred on an injured party from a source other than the defendant." Brief for Petitioners at 31. The petitioners have, however, cited no cases in which the collateral source rule barred taking into account benefits received by a plaintiff through a defendant's direct and intentional efforts—efforts that the plaintiff sought and expected the defendant to make—as is the case here.[24]

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23 *See* Note, *Tax Shelter Schemes and Damages in the Eighth Circuit—Hayden v. McDonald*, 18 Creighton L. Rev. 1307, 1327 (1985) ("The realities of the situation suggest that without the defendant/promotor's creating such an investment, there would be no tax deductions available to the plaintiff. . . . Thus, the [collateral source] doctrine should not apply. . . ."); Note, *Tax Consequences of Rescission: The Interplay Between Private and Public Law*, 42 U. Chi. L. Rev. 562, 567-68 (1975) (tax consequences in a tax shelter project are not collateral, since "the tax consequences . . . are at the heart of the bargain" and "are at least as much the object of the transaction between the parties as the anticipated flow of profits," and if the seller failed to provide the tax benefits promised he might be liable to the purchaser in damages for them).

24 The petitioners have cited cases where defendants were not permitted to offset against damage awards disability or unemployment benefit payments made to plaintiffs from state or federal funds to which defendants had indirectly contributed, through taxation or otherwise. *Eichel v. New York*

A source of confusion about the collateral source rule is the inevitable fact that there are three parties to the tax benefit transaction involved here: the petitioners, the respondents, and the Government. The fact that one of the parties ultimately confers the benefit does not alter the fact that another party secured the right to the benefit and passed it to the third. An example clarifies this. Suppose that Alotel Associates took the petitioners' funds and purchased certificates of deposit from a bank. Suppose further that Alotel Associates then distributed all of those certificates to the petitioners, who promptly took them to the bank and received payments equaling their original investments. Meanwhile, their partnership interests became worthless and they commenced an action for fraud. It would be unthinkable that they could recover under these circumstances simply because the payments they received ultimately came from a bank rather than from Alotel Associates. Whether Alotel Associates spent its funds to secure certificates of deposit for the petitioners or to secure tax benefits for them is immaterial.[25]

Cent. R. Co., 375 U.S. 253, 254 (1963) (Railroad Retirement Act benefits not directly attributable to employer's contributions); *NLRB v. Gullett Gin Co.*, 340 U.S. 361, 364 (1951) (state unemployment compensation); *Kauffman v. Sidereal Corp.*, 695 F.2d 343, 346-47 (9th Cir. 1982) (Court of Appeals, noting a split among the circuits, disallows deduction of unemployment benefits from backpay award under Title VII). These cases have no bearing here.

The petitioners' citations (Brief for Petitioners at 31) to "tax benefit" cases are inapposite as well, because in none of those cases did the defendant cause the plaintiff to receive tax benefits. In fact, in *Cereal Byproducts Co. v. Hall*, 16 Ill. App. 2d 79, 81, 147 N.E 2d 383, 384, *aff'd*, 15 Ill. 2d 313, 155 N.E.2d 14 (1958), cited by the petitioners, the court stated that it would not consider the plaintiff's tax savings because "[t]he defendants *did not cause* nor did they provide the funds for the [plaintiff's] tax refund." (emphasis added).

25 It is no answer to the example in the text that, unlike a certificate of deposit, tax benefits have no fixed value until they are in the hands of one with taxable income against which to use them. Whether the value of the tax benefits is fixed when they are earned by the partnership's expenditures, or is fixed later on, does not alter the fact that the tax benefits had value and that

C. *Tax Benefits Must Be Subtracted Under Section 12(2)*

1. *Section 12(2) Must Be Read* In Pari Materia *With Rule 10b-5*

Section 12(2) permits an investor who has been induced to purchase a security by a misleading prospectus or oral communication to sue the offeror or seller of the security:

> . . . either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

After asserting that the history and language of Section 12(2) do not permit courts to subtract tax benefits produced by tax shelters from securities damage awards, the Government argues that rules of statutory interpretation require the same damage award under Rule 10b-5 and Section 12(2). Brief for Government at 20. We agree with the Government that the two securities statutes are to be construed *in pari materia*,[26] but the conclusion that follows from this is opposite to the Government's. The effect of interpreting the statutes *in pari materia* is to construe the language of the 1933 Act to provide the same remedy as the 1934 Act.

It would be anomalous to impose a harsher penalty under Section 12(2), which gives a claim for lack of "reasonable care," than under Rule 10b-5, where liability may only be imposed for conduct involving scienter. *See Ernst & Ernst v.*

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such value came about as a direct result of the respondents' efforts in building the motel and applying the funds they received in the manner prescribed by the Internal Revenue Code.

26 *See Globus v. Law Research Service, Inc.*, 418 F.2d 1276, 1286 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970); *see also Herman & MacLean v. Huddleston*, 459 U.S. 375, 380 (1983); *United States v. Naftalin*, 441 U.S. 768, 778 (1979); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 206 (1976); *Silver v. New York Stock Exchange*, 373 U.S. 341, 357 (1963).

Hochfelder, 425 U.S. 185, 194-214 (1976) (comparing the standards).

Similarly, in *Globus v. Law Research Service, Inc.*, 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970), the leading case in the area, the Second Circuit decided that punitive damages may not be awarded under Section 17(a) of the 1933 Act for among other reasons the "actual damages" limitation of the 1934 Act. The *Globus* Court noted that punitive damages are unavailable for a violation of Section 10(b) of the 1934 Act, 418 F.2d at 1283, and that Section 17(a) is "virtually identical" to Rule 10b-5, "except that the statutory provision applies only to the conduct of sellers, while the rule governs the conduct of both buyers and sellers." *Id.* at 1279 n.1. The court thought it would create an "unfortunate dichotomy" between the two Acts if sellers and buyers were prohibited from recovering punitive damages under the 1934 Act but buyers could recover punitive damages under the 1933 Act for equally blameworthy behavior. *Id.* at 1286.[27]

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27 Courts have applied the *in pari materia* doctrine across a broad spectrum of 1933 Act and 1934 Act provisions. *See, e.g., Berger v. Bishop Inv. Corp.*, 695 F.2d 302, 308 (8th Cir. 1982) (reading the two Acts *in pari materia* to find no inconsistency between Section 12(2) and Section 10(b) or Rule 10b-5); *Gunter v. Hutcheson*, 674 F.2d 862, 876-77 (11th Cir.) (reading the two Acts *in pari materia* to apply defense available under Section 29(c) of the 1934 Act to claim under Section 17(a) of the 1933 Act), *cert. denied*, 459 U.S. 826 (1982); *Ballard & Cordell Corp. v. Zoller & Danneberg Exploration, Ltd.*, 544 F.2d 1059, 1065-66 (10th Cir. 1976) (affirming lower court's holding that "security" is not to be defined differently under 1934 Act than under 1933 Act), *cert. denied*, 431 U.S. 965 (1977); *Occidental Life Ins. Co. v. Pat Ryan & Assoc., Inc.*, 496 F.2d 1255, 1267 (4th Cir.) (reading Section 29(b) of the 1934 Act *in pari materia* with other securities laws remedies), *cert. denied*, 419 U.S. 1023 (1974); *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1298 n.65 (2d Cir. 1973) (relying "without discussion on the proposition that the 1933 and 1934 Acts are to be construed *in pari materia*" in examining Sections 11 and 12 of the 1933 Act and Sections 10(b) and 20(a) of the 1934 Act).

2. *Regardless Of* In Pari Materia *Concepts, Tax Benefits Must Be Subtracted In Rescission And Restitution Under Section 12(2)*

We agree with the Government that Section 12(2) must be understood in the light of the common law of rescission and restitution. These principles support the decision below and lead to the same measure of damages as under Rule 10b-5.

Rescission is the act of undoing the original transaction, and restitution is the return of property to each party in an effort to restore the *status quo ante*. *See* D. Dobbs, *Handbook on the Law of Remedies* § 4.1 at 222 (1973); 5C A. Jacobs, *Litigation and Practice Under Rule 10b-5* § 260.03[c][vi] at 11-56, 11-65 (2d ed. 1985); C. McCormick, *Handbook on the Law of Damages* § 121 at 448 (1935); *see also* 2 J. Story, *Commentaries on Equity Jurisprudence* § 962 (1918) ("Necessity of Placing Parties in Statu Quo."). As noted above, this purpose parallels that of Rule 10b-5. *See* II.A., *supra*.

A party seeking rescission and restitution must restore whatever he has received from the transaction:

> [I]t is well settled that any person demanding the rescission of a contract to which he is a party must restore or offer to restore to the other party whatever he may have received under the contract in the way of money, property, or other consideration or benefit.

2 H. Black, *Black on Rescission & Cancellation* § 617 at 1417 (1916). Similarly, Professor Corbin states that where a defendant has "rendered a part performance of value," his "part performance must be allowed as a credit against the value of the full performance promised by the defendant." 5 A. Corbin, *Corbin on Contracts* § 1114 at 607 (1964). *See also* D. Dobbs, *Handbook on the Law of Remedies* § 9.4 at 622 (1973) (rescinding plaintiff must tender "whatever he . . . got under the contract, or at least its money value"); 1 G. Palmer, *The Law of Restitution* § 3.11 at 294 (1978) (when plaintiff seeks restitution under contract he must return or account for "the value he

received"); *Restatement of Restitution* § 65 (1937) (right of restitution in transaction voidable for fraud or mistake "is dependent upon his return or offer to return to the other party anything which he received as part of the transaction or, . . . its value"); 2 J. Story, *Commentaries on Equity Jurisprudence* §§ 962-966 at 341-45 (1918) (general rule of rescission requires that plaintiff must return defendant to *status quo*). The restoration requirement exists whether the "right to restitution is based on fraud, innocent misrepresentation, breach of contract, or any other ground." 1 G. Palmer, *The Law of Restitution* § 3.11 at 294 (1978). *See also Restatement of Restitution* § 65 (1937).

To fail to require the plaintiff to restore the value of the defendant's performance may unfairly benefit the plaintiff:

> A plaintiff who recovers the full value of such performance as he may have rendered, and at the same time is allowed to retain a part performance that he had received, is thereby put in a better position than he occupied before the contract was made. This is contrary to the theory of [restitution]. . . .

5 A. Corbin, *Corbin on Contracts* § 1114 at 607 (1964).

The result urged by the petitioners and the Government is a prime example of the outcome against which Professor Corbin cautioned. Permitting the petitioners both to retain the tax benefits produced by the respondents' efforts and to recover the full consideration they paid for their initial investment would put the petitioners in a much better net economic position than they occupied before entering the transaction.[28]

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28 Relying primarily upon the language of the *Restatement of Restitution* § 157, the Government argues that in calculating a restitutionary award the plaintiff buyer is required to restore to the defendant only the "direct product" of the plaintiff's security ownership. Brief for Government at 10. Even assuming, without conceding, that tax benefits are not a "direct product" in this case, the Government's position elevates a single nebulous formulation of the rule to talismanic proportions and ignores the concept underlying the rule.

Based on these principles, the Eighth Circuit correctly interpreted Section 12(2) to require the subtraction of tax benefits produced by the Alotel Associates tax shelter to effect restitution and return the parties to the *status quo ante*.

Citing *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975) (Brief for Petitioners at 17-19), the petitioners argue that there should be no subtraction of tax benefits from the damage award because the only subtraction authorized by Section 12(2) is of "income received," and tax benefits are not "income received."[29]

There are two answers to this. First, tax benefits are more properly regarded as a return of, or a reduction in, "considera-

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29 *United Housing* is inapposite. The Court concluded that the purchase of shares in a cooperative housing project constituted the purchase of living space, not a security. The tax benefits that flowed from the purchase did not constitute "profits" within the meaning of the rule defining a security in terms of the expectation of profits from the managerial efforts of others. The Court never reached the question presented here, where tax benefits are the very *raison d'etre* of the investment in a tax shelter. Indeed, the Court noted that "[e]ven if these tax deductions were considered profits, they would not be the type associated with a security investment since they do not result from the managerial efforts of others." *Id.* at 855 n.20. Here, of course, the opposite is true: the tax benefits arose solely through the respondents' management of Alotel Associates.

The SEC filed an *amicus* brief in *United Housing* urging that the co-op shares be held to be securities. *See* Brief for Securities and Exchange Commission as *Amicus Curiae*, *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975). While there is no such issue here, the SEC's reasoning does apply:

> The lure of reductions in taxes and costs—such as those that were promised the investors in the instant case—may be as strong an inducement to invest as the hope of direct monetary gain, and one as likely to mislead an innocent investor. It is immaterial whether the economic inducement is in the form of cash payments or, as here, reduced carrying charges and tax advantages.

Id. at 15-16.

tion paid" than as "income received," since the Government is subsidizing the cost of the investment.[30]

Second, even if the "consideration" view is not accepted, an interpretation of "income received" to mean "value" received, as the Eighth Circuit understood it (*Austin* II, 768 F.2d at 955), is necessary to attain the goal of restoring the *status quo ante*. The term "income received" is nowhere defined in the 1933 or 1934 Acts. Under such circumstances, the term must be read in accordance with the purpose of the provision. *United Housing Foundation, Inc. v. Forman*, 421 U.S. at 849; *Church of the Holy Trinity v. United States*, 143 U.S. 457, 459, 461 (1892). As all parties and the *amici* seem in accord that the purpose of Section 12(2) is rescission and restitution, the result adopted by the Eighth Circuit follows at once. While we believe that the petitioners' tax benefits are more properly characterized as a return or subsidy of "consideration paid," either approach accomplishes the purpose of rescission—a subtraction of the benefits received in the course of the investment.

D. *Interest Was Properly Awarded Only On The Amount The Petitioners Were Out Of Pocket At Any Given Time*

The Eighth Circuit determined that interest should be awarded "only on the amount of money [the petitioners] were out-of-pocket at any given time." *Austin II*, 768 F.2d at 959. The petitioners do not appear to take issue with this under Rule 10b-5, where the award of interest is discretionary. As discussed in II.C.1., *supra*, *in pari materia* considerations

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30 For example, one of the effects of tax deductions taken by the petitioners was a reduction in the basis of their investments, the tax-law analog to consideration paid. Also, at the damages retrial after *Austin I*, the petitioners' expert witness stated that the tax benefits were not income received and the respondents' expert witness testified that both from an accounting and an investing standpoint, the petitioners' tax benefits were properly categorized as a reduction in their capital investment. (J.A. 183-84, 205). This view also finds support in the most recent Treasury Regulations requiring partners' capital accounts to be reduced by various tax deductions. Treas. Reg. § 1.704-1(b)(2)(iv)(b) (1985).

compel the same result under Section 12(2) as under Rule 10b-5.

Under Section 12(2), the petitioners argue that the placement of the word "interest" after "consideration paid" and before "income received" necessitates the conclusion that they are entitled to interest on their entire consideration paid ($157,500) for some twelve years, even though they were barely out of pocket for most of that time.

As an initial matter, if tax benefits are regarded as a reduction of the net amount invested, *i.e.*, a reduction or subsidy of "consideration paid," the petitioners' statutory construction argument against applying interest on the net amount outstanding loses its validity. They have been awarded interest on the amount of "consideration paid" outstanding at any given time.

Even assuming that the petitioners' tax benefits ought to be treated as "income received" rather than as a return of "consideration paid," nothing in Section 12(2) prevents a court from imputing interest on income received, which has the same effect as applying interest only on the net amount out of pocket, where to do so is necessary to return the purchaser to the *status quo ante*. The purpose of an award of prejudgment interest under the securities laws is to compensate plaintiffs for the loss of the use of their money.[31] To the extent they receive some of their money back, there should be less to apply interest to. *See Murphy v. Cady*, 30 F. Supp. 466, 470 (D. Me. 1939), *aff'd*, 113 F.2d 988 (1st Cir.), *cert. denied*, 311 U.S. 705 (1940); L. Loss, *Fundamentals of Securities Regulation* 1020 (1983) (Section 12(2) damages are "the difference between the purchase price and the plaintiff's resale price, plus interest,

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31 *See Scheve v. Clark*, 596 F. Supp. 592, 596 (E.D. Mo. 1984) (plaintiffs entitled to recover damages under securities laws, including Section 12(2), awarded interest at rate that will adequately compensate them for use of their money); *Cant v. A.G. Becker & Co., Inc.*, 384 F. Supp. 814, 815 (N.D. Ill. 1974) (in securities cases prejudgment interest may be awarded where plaintiff has been denied beneficial use of his funds).

and less any income or return of capital (with interest) that the plaintiff received on the security").

The fact that other provisions of the securities laws have not provided for interest has not prevented courts from awarding interest on equitable grounds when appropriate. For example, an award of interest under both Section 16 and Rule 10b-5 of the 1934 Act is within the discretion of the trial court, even though neither provision mentions interest. Whether interest will be awarded under those provisions is to be determined by considerations of fairness. *See, e.g., Blau v. Lehman*, 368 U.S. 403, 414 (1962) (Section 16(b)); *Rolf v. Blyth, Eastman Dillon & Co., Inc.*, 637 F.2d 77, 87 (2d Cir. 1980) (Rule 10b-5); *Wessel v. Buhler*, 437 F.2d 279, 284 (9th Cir. 1971) (Rule 10b-5). In the present case, fairness dictates that the damage formula permit the lower courts to impute interest on the value an investor receives. Any other result increases damage awards beyond a plaintiff's actual injury, and thus creates a penalty or forfeiture against the defendants.[32]

III. This Court Should Correct The Eighth Circuit's Plain Error Of Doubling The Petitioners' Entire Recovery

We request that the Court consider an issue not raised by the petition for certiorari, namely, whether the Court of Appeals committed a plain error by doubling the petitioners' entire award, damages and interest. *Austin II*, 768 F.2d at 960-61.[33]

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32 The petitioners rely on *Johns Hopkins Univ. v. Hutton*, 297 F. Supp. 1165 (D. Md. 1968), *aff'd in part and rev'd in part*, 422 F.2d 1124 (4th Cir. 1970), in opposition to this. The *Johns Hopkins* decision analyzed Section 12(2)'s rescission remedy. 297 F. Supp. at 1231. The court did not reject the idea of imputing interest on value received, but said it would not impute interest even if it had discretion to do so, because imputing interest in that case would not restore the *status quo ante*, but would instead "put the buyer in a worse, and the seller in a better, position than the status quo ante." *Id.* That is the opposite of the situation here.

33 Under Rule 34.1(a) of the Rules of the Supreme Court, this Court "[a]t its option, . . . may consider a plain error not among the questions presented but evident from the record and otherwise within its jurisdiction to

The petitioners' total damages with interest were $14,473, calculated as follows:

	Investment	-	*Tax Benefits*	=	*Damages*	+	*Interest*	=	*Recovery*
Randall	$ 35,000	-	$ 36,404	=	$-1,404	+	$ 1,657	=	$ 253
Austin	35,000	-	33,333	=	1,667	+	2,166	=	3,833
Anderson	35,000	-	29,615	=	5,385	+	4,010	=	9,395
Neumann	52,500	-	57,014	=	-4,514	+	5,506	=	992
									$14,473

In order to take the tax consequences of the petitioners' recovery into account, 768 F.2d at 960, the Eighth Circuit assumed that the petitioners would have to pay taxes on their awards at a 50% rate and therefore doubled or "grossed up" the petitioners' recovery, to a total of $28,946. *Id.* at 960-61. The court chose to "adopt Loftsgaarden's method" of considering tax consequences. *Id.* at 960.[34]

Loftsgaarden never urged the court to gross up the interest portion of the petitioners' recovery in order to "net out" to 8% interest after taxes, nor was there any logical reason for the court to do so. The petitioners' award should accordingly be calculated as follows:[35]

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decide." U.S. Sup. Ct. Rule 34.1(a), 28 U.S.C.A. *See Washington v. Davis*, 426 U.S. 229, 238 (1976).

34 The Eighth Circuit stated that Loftgaarden's method "takes into account the fact that, because each plaintiff will have to pay taxes on his award, the award must be calculated in an amount which each plaintiff would have to recover in order to 'net out' their actual damage figure." 768 F.2d at 960.

35 Because there is little in the Record, we cannot quarrel with the Eighth Circuit's use of a 50% marginal income tax rate to gross up the petitioners' award, as opposed to a possible lower rate. In other circumstances, plaintiffs may be able to treat an award as a capital gain, at lower rates, resulting in a smaller gross-up figure.

	Damages	+	*Amount Needed to Gross Up*	+	*Interest*	=	*Total Recovery*
Randall	$-1,404	+	$ 0	+	$1,657	=	$ 253
Austin	1,667	+	1,667	+	2,166	=	5,500
Anderson	5,385	+	5,385	+	4,010	=	14,780
Neumann	-4,514	+	0	+	5,506	=	992
							$21,525

The only reason to gross up the award at all is the assumption that, precisely *because* the petitioners received tax benefits earlier, the damage award will be taxed.[36] It follows that only that portion of the award which is taxed for that reason should be grossed up. Interest is not taxed as a result of earlier tax benefits having been taken, and thus should not be grossed up. This will put the petitioners on an even footing with other investors who, after their net damages are ascertained, receive only simple interest.

IV. Other Points Raised By The Petitioners And The Amici

A. *Alleged Inconsistency With Supreme Court Precedent*

The petitioners argue that the Eighth Circuit's holding in *Austin II* failed to follow this Court's holdings in *Hanover Shoe, Inc. v. United Shoe Machinery Corp.*, 392 U.S. 481 (1968), *Norfolk & W. Ry. Co. v. Liepelt*, 444 U.S. 490 (1980), and *Jones & Laughlin Steel Corp. v. Pfeifer*, 462 U.S. 523 (1983). Brief for Petitioners at 25-27.

In *Hanover Shoe*, an antitrust case involving damages for lost profits, this Court held that pre-tax lost profits must be

36 Had the petitioners never received any tax benefits that reduced their basis, the damage award would be a nontaxable return of capital. 1 J. Mertens, *Law of Federal Income Taxation* § 5.06 (J. Doheny rev. ed. 1981) ("When amounts received under a lawsuit . . . represent a loss of profits the amount is taxable income; when all or a part of the amount represents damages for lost capital such amount is not taxable."); *see Mathey v. Commissioner*, 177 F.2d 259, 260-61 (1st Cir. 1949), *cert. denied*, 339 U.S. 943 (1950).

awarded, since the plaintiff's damage award would be taxed when received. 392 U.S. at 503. In *Liepelt* and *Pfeifer*, the Court held that an award for a decedent's lost income should be based on after-tax earnings since wrongful death awards "are not taxable income to the recipient." *Liepelt*, 444 U.S. at 496; *see Pfeifer*, 462 U.S. at 534.

The petitioners argue that these three cases say that tax consequences are not to be considered unless a damage award is non-taxable. This has nothing to do with the treatment of tax benefits *already received*, as here, as opposed to the treatment of tax "consequences" of a recovery so as to prevent windfalls (*Liepelt* and *Pfeifer*) or shortfalls (*Hanover Shoe*) for the plaintiff.

B. ***The Petitioners Will Not Have To Amend Their Returns***

If the petitioners really believed that they "may" have to amend their returns to give back all their tax benefits, Brief for Petitioners at 38-41—a position that the Government does not assert—it is not clear what they hope to have gained by seeking certiorari. The fact is, the petitioners have received permanent tax benefits. *Austin II*, 768 F.2d at 955.

The petitioners' argument is drawn from *Burgess v. Premier Corp.*, 727 F.2d 826, 838 (9th Cir. 1984) ("[U]nder the tax benefit rule, [plaintiffs'] prior tax benefits will be disallowed. Although this court cannot directly disallow the prior tax benefits because plaintiffs' tax liabilities are not directly before us, we presume that the IRS will do its duty if the doctors should actually recover on their judgments and thereafter fail to file amended returns as required by law."), and *Western Federal Corp. v. Davis*, 553 F. Supp. 818, 820 (D. Ariz. 1982) ("plaintiffs will have to amend their income tax returns to report those funds as income" and thus "[t]he amounts claimed as a deduction and the amounts later reported as income will wash out and the net tax benefit will be nothing"), *aff'd sub nom., Western Federal Corp. v. Erickson*, 739 F.2d 1439 (9th Cir. 1984).

In the first place, *Burgess* and *Western Federal Corp.* were wrong in stating a need to amend prior returns in any event.[37] Under the tax benefit rule, the petitioners would, at worst, merely report the recovery of certain amounts previously deducted as taxable income in the year a money judgment was recovered. *See Hillsboro National Bank v. Commissioner*, 460 U.S. 370, 377-81 (1983). As shown by this very case, that still leaves a very large tax benefit in the petitioners' hands.

Second, the transaction at issue was not, as petitioners claim, void *ab initio*. *Cf. Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 387-88 (1970) (pursuant to Section 29(b), contracts made in violation of the 1934 Act are voidable, not void); 5C A. Jacobs, *Litigation and Practice Under Rule 10b-5* § 260.03 [c][vi] at 11-60 n.24 (2d ed. 1985). It was only voidable on account of the misrepresentations. 1A A. Corbin, *Corbin on Contracts* § 228 (1963). Under the tax laws, the petitioners would be entitled to tax benefits up until the time they exercised their option to avoid the contract, if that time ever came.

Finally, we agree that if a judgment, *because of earlier tax benefits*, was itself taxable, the judgment should be grossed up to account for that. *See* III., *supra*. However, the Ninth Circuit went far overboard in establishing a fixed rule that such a gross-up would always eliminate tax benefits, when it is clear that the situation can differ widely depending on the nature of the tax shelter, the duration of the tax shelter, and other factors, as shown by the facts now before the Court.

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37 The sole authority cited by the Ninth Circuit, "Mertens *Law of Federal Income Tax*, § 7.37," *Burgess*, 727 F.2d at 838, was read erroneously. It does not stand for the principle asserted. In fact, it stands for the correct principle.

C. *Deterrence Of Disclosure Violations*

The petitioners and the amici argue that application of the Eighth Circuit's decision would discourage needed private enforcement of the antifraud provisions of the securities laws. Brief for Petitioners at 32-36; Brief for Government at 27; Brief for Hon Industries, Inc. at 25-29.

This contention is erroneous for three reasons. First, application of the tax benefit offset rule does not reduce a defrauded investor's actual damages. Rather, the tax benefit offset rule insures that an investor receives his actual damages—only the amount that he has lost. This result is consistent with, not in conflict with, the purpose of Section 12(2) of the 1933 Act and Section 28(a) of the 1934 Act. Carried to its logical conclusion, the private enforcement argument would "encourage" suits in situations where there was no damage under anyone's view, *e.g.*, where there was a full return, as dividends, of all a plaintiff invested.

Second, the legislature, not the judiciary, is the appropriate body to determine whether to encourage the filing of private damage actions.[38] As embodied in Section 12(2) of the 1933

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38 *Alyeska Pipeline Serv. Co. v. Wilderness Soc'y*, 421 U.S. 240, 247 (1975).

In addition to the argument based on the decision in *Alyeska*, in past cases this Court has rejected similar arguments advanced by the SEC to broaden the securities laws and expand litigation in the name of enhanced deterrence. *See, e.g., International Brotherhood of Teamsters, Chauffeurs, Warehousemen & Helpers of America v. Daniel*, 439 U.S. 551, 570 (1979) (rejecting SEC's contention that non-contributory, compulsory pension plans are securities); *Securities and Exchange Commission v. Sloan*, 436 U.S. 103, 115-16 (1978) (rejecting SEC's argument that the remedial purposes of the 1934 Act require successive suspension of trading in particular securities to maintain fair and orderly markets, even assuming that such successive suspensions are necessary to a satisfactory remedy); *Radzanower v. Touche Ross & Co.*, 426 U.S. 148, 156 n.12 (1976) (SEC's suggestion that the broad venue provisions of the 1934 Act should govern a securities action against a bank as an aid to enforcement was rejected in part because such policy arguments "are more appropriately addressed to Congress than to this

Act and Section 28(a) of the 1934 Act, Congress has chosen to provide no greater incentive for a potential private plaintiff than the award of his "actual damages."

In *Globus v. Law Research Service, Inc.*, 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970), the Second Circuit, while acknowledging that punitive damages would deter violations of the Act, pointed out that the securities laws provide many means to punish and deter violators, even absent punitive damages. 418 F.2d at 1284-85. The court thus declined to permit an expanded remedy for punitive damages.

Finally, there are cases where, without a rule taking tax benefits into account, a defrauded investor might have no remedy. *Cf. Sharp v. Coopers & Lybrand*, 649 F.2d 175, 190-91 (3rd Cir. 1981) (absence of represented tax benefits one component of fraud), *cert. denied*, 455 U.S. 938 (1982); *Beggs v. Dougherty Overseas, Inc.*, 287 F.2d 80, 83 (2d Cir. 1961) (where parties had income tax benefits in mind when they entered into employment contract, tax benefits that were lost when employee was wrongfully discharged "were properly allowed as elements of damage"). Ignoring tax benefits in such cases would discourage, not encourage, private enforcement.

The balance Congress has established between private deterrence and other deterrence under the securities laws should not be altered except by Congress. *See, e.g., Touche Ross & Co. v. Redington*, 442 U.S. 560, 578 (1979) (in denying implication of a private right of action under Section 17(a) of the 1934 Act,

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Court"); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 212-14 (1976) (rejecting SEC's contention that Rule 10b-5 should encompass both intentional and negligent behavior); *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418, 426 (1972) (rejecting SEC's argument that Section 16 of the 1934 Act applies to all sales within six months by one who has become a ten percent owner by voluntary purchase, regardless of amount of seller's holdings at the time of the sale); *Blau v. Lehman*, 368 U.S. 403, 411-14 (1962) (rejecting SEC's argument that Section 16(b) of the 1934 Act should be interpreted to permit recovery of short-swing profits from partnerships in order to close a loophole in the statutory scheme).

the Court reemphasized "that generalized references to the 'remedial purposes' of the 1934 Act will not justify reading a provision 'more broadly than its language and the statutory scheme reasonably permit' ").

D. *"Banking A Fraud"*

The petitioners contend that if their damage award is reduced by the amount of tax benefits they received, the respondents will benefit at the Government's expense and the Government will thereby be banking a fraud. Brief for Petitioners at 36, relying on *Burgess v. Premier Corp.*, 727 F.2d 826, 838 (9th Cir. 1984) ("we decline to make the government the banker for fraudulent tax shelter activity").

The Second Circuit answered this in *Salcer*:

> The government got the residential development that it hoped to encourage by offering the tax benefits taken by the plaintiffs. Thus, it is "banking" precisely what it agreed to "bank." There is no suggestion that the project did not meet federal requirements as a viable housing development entitling its owners to tax benefits.

Salcer, 744 F.2d at 941.

What the Government really wants is a large award to the petitioners which it can tax, thus recouping some of the tax benefits it granted. This is simply unjust, and flies in the face of Congressional intent that tax benefits be conferred for the construction of such real estate projects. *See* 26 U.S.C. § 465(c)(3)(D). There was no fraud on the Government here, there was no misrepresentation as to the entitlement to tax benefits, and there were no claims to tax benefits that were not supported by exactly the kind of expenditures the Government wished to bring about. All tax benefits were the subject of Internal Revenue Service audits and were approved.

The Government also complains that the Eighth Circuit's decision results in a transfer of tax benefits to the respondents. But, when the lower courts ordered the respondents to reim-

burse the petitioners for their net economic loss, the respondents became the financiers of the project, or at least of so much of it as the Government had not funded. To the extent those benefits are deemed by the Government, *see* Brief for Government at 21, to be "transferred" to the respondents by subtracting them from the damage award, that is where they now belong.

E. *Different Damage Awards Based On Actual Injury*

The petitioners argue that taking tax benefits into account results in different damage awards for investors in different tax brackets. Brief for Petitioners at 37. This is true, but irrelevant.

The principle works no differently from other tort damage principles that require a defendant to take the plaintiff as he finds him. Prosser & Keeton, *The Law of Torts* § 43 (5th ed. 1984); C. McCormick, *Handbook on the Law of Damages* § 76 (1935); 22 Am. Jur. 2d *Damages* § 122 (1965). A recklessly driven car in a collision with both a luxury car and a compact car leads to more damages for the owner of the former than the latter. That does not make an "actual damages" rule anomalous.

F. *"Speculativeness" Of The Petitioners' Tax Consequences*

The petitioners claim that is is inappropriate for a court in a securities fraud action to consider tax consequences because such consideration would necessarily be premature and speculative. The petitioners argue that there are so many "unknowns" involved that it is "impossible for a trier of fact to make an accurate allocation." Brief for Petitioners at 42. In the first place, these considerations are inapplicable here, where the petitioners' tax status is fixed and unchangeable. More generally, as to speculative evidence, if a party cannot satisfy his burden of proof on an issue he simply will not have a ruling in his favor on it. This is not a reason to prevent him from offering his proof.

In *Norfolk & W. Ry. Co. v. Liepelt*, 444 U.S. 490, 494 (1980), a wrongful death action brought under the Federal Employers' Liability Act, this Court specifically held that evidence as to future tax consequences is neither too speculative nor too complex to be considered and resolved by a jury. *In re Air Crash Disaster*, 701 F.2d 1189, 1192 (7th Cir.), *cert. denied*, 464 U.S. 866 (1983); *Fanetti v. Hellenic Lines Ltd.*, 678 F.2d 424, 431 (2d Cir. 1982), *cert. denied*, 463 U.S. 1206 (1983); *O'Connor v. United States*, 269 F.2d 578, 584 (2d Cir. 1959). Jury consideration of the petitioners' tax benefits is no more uncertain or speculative than many other determinations made by juries. *Norfolk & W. Ry. Co. v. Liepelt*, 444 U.S. at 494.[39]

The petitioners further argue that having a jury consider the likelihood of an IRS audit of their past tax deductions, as well as the possible results of such an audit, involves more uncertainty and speculation. Moreover, it creates a "dilemma" for the petitioners because "[p]roving the weakness of [their] 'tax shelter benefits' creates a road map for an IRS audit, but failing to offer proof reduces the damages available." Brief for Petitioners at 43. The petitioners do not explain why, if their tax shelter benefits are undeserved, they should not provide this road map. They have declared under penalty of perjury on their tax returns, *see* 26 U.S.C. § 6065, that the tax benefits were warranted; it is not too much to expect that they will take the same position in their lawsuit.

The district courts have substantial expertise in evaluating tax benefits; they do so in tax cases every day. They will not lose their expertise in the midst of a securities case.

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39 Indeed, the trier of fact must often consider and resolve factual issues fraught with future uncertainty. *Sea-Land Serv., Inc. v. Gaudet*, 414 U.S. 573, 588-90 (1974) (allowing decedent longshoreman's dependents to recover damages for loss of support, services and society under federal maritime law, despite objections that such damages are speculative); *Palmer v. Connecticut Ry. Co.*, 311 U.S. 544, 558-62 (1941) (allowing future damages for breach of long-term lease, despite uncertainty as to future rental value of property).

G. *Unjust Enrichment*

While the lower courts found there was no unjust enrichment of the respondents, and the issue was not among the questions presented for certiorari, the petitioners repeatedly assert that the respondents were "unjustly enriched." This is unsupported by the record and is in any event a red herring. The argument is apparently advanced in an effort to take advantage of *Affiliated Ute*, *supra*, where defrauded sellers of stock could recover appreciation in the hands of the buyers lest the buyers be unjustly enriched. Of course, this has nothing to do with anything here.

Second, even if there were unjust enrichment, the petitioners abandoned their claims for it at trial. *See* n.5, *supra*.

Third, even if the petitioners had not dropped their claims, and could prove unjust enrichment, this might increase their damages but would not free them of the offset of tax benefits from the increased award.

Finally, the "facts" the petitioners cite in support of their contention are inaccurate. One source of the petitioners' charges is the statement in the dissenting opinion in *Austin II* that "[t]here was evidence at trial showing Loftsgaarden received over $100,000 profit from the investment scheme." 768 F.2d at 963. Apparently, the dissent relied on the finding of fact in the district court that the Offering Memorandum projected "that the developer and construction company would receive a total of $103,900 for 'overhead and profit.' " (*See* J.A. 118; Pl. Ex. 2; Tr. 42). There was no evidence that these sums were realized.

The petitioners also recite a list of figures representing payments the respondents received from Alotel Associates for services performed. Brief for Petitioners at 4-5, 35. While some of the figures the petitioners cite are incorrect or misleading, as detailed below, it is more important to note that neither the petitioners nor the courts involved in this case have pointed to any evidence that the respondents impermissibly profited

from the financial transactions at issue, or that any fees or commissions received by the respondents were unreasonable or unnecessary.[40]

Turning to the figures listed by the petitioners, it is alleged that 2361 Corp. received $23,524 for "reimbursement." Brief for Petitioners at 4. An examination of the trial exhibits cited by the petitioners reveals no $23,524 sum.

The petitioners also assert that 2361 Corp. received $63,724 for undisclosed purposes. Brief for Petitioners at 4-5. Defendants' exhibit 41g shows that Star Crown Industries Inc. had been employed by 2361 Corp. to provide various fixtures at a cost of $6,296.65. The same exhibit shows that the Singer Company had been employed by 2361 Corp. as the "material supplier of heating units" at a cost of $57,427.84. The sum of the above two figures is $63,724.49.

The petitioners also assert that the Offering Memorandum omitted information about Loftsgaarden's control of Alotel, Incorporated, PDRC, and 2361 Corp. While it is true that the opinion in *Austin I* characterized the district court's finding as one "that Loftsgaarden had omitted any explanation of the role his closely-held corporations would assume in the development," 675 F.2d at 175, the Offering Memorandum did in fact disclose certain information and make certain projections as to the respondents' expected compensation that tend to negate the petitioners' implication that the respondents' anticipated reward for their work was kept secret. For example, as to Loftsgaarden's control of Alotel, Incorporated, the forecasts of Alotel Associates prepared by Touche Ross & Co., which were included in the Offering Memorandum, said that Loftsgaarden would be an officer and majority shareholder of Alotel, Incorporated. (J.A. 120; Pl. Ex. 2; Tr. 42). The Offering Memorandum also revealed that the developers of the

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40 Loftsgaarden testified that he received no profit as the owner of PDRC (Tr. 658-59), or as the owner of 2361 Corp. (Tr. 668), and that the fee charged for the design of the motel, by the architectural firm of which he was a part owner, was not unreasonable (Tr. 669).

project contemplated entering into a construction contract with a construction company:

> owned or controlled by persons who are also in ownership or control of the corporate general partner [Alotel, Incorporated] of the Partnership. It is therefore possible that larger than usual profits could be made by said persons in connection with the construction of the project.

(J.A. 96; Pl. Ex. 2; Tr. 42; *see* J.A. 120; Pl. Ex. 2; Tr. 42). Finally, an examination of the provision of the Offering Memorandum governing compensation of the general partner demonstrates that the general partners' opportunity to profit as manager of the Alotel Associates' property was tied to the success of the enterprise. (*See* J.A. 99; Pl. Ex. 2; Tr. 42).

CONCLUSION

The judgment of the Court of Appeals should be affirmed in all respects except that, insofar as it awarded the petitioners twice the interest on their damages, the judgment should be modified to award only single interest.

Respectfully submitted,

John M. Friedman, Jr.
Charles Chasin
DEWEY, BALLANTINE, BUSHBY,
PALMER AND WOOD
140 Broadway
New York, New York 10005
Telephone: (212) 820-1100

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(4)

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IN THE SUPREME COURT OF THE UNITED STATES

October Term, 1985

DR. WILLIAM C. RANDALL, DR. ROGER E. AUSTIN, DR. TOM W. ANDERSON and DR. MYREL A. NEUMANN,

Petitioners,

v.

B. J. LOFTSGAARDEN; ALOTEL INCORPORATED, a Minnesota corporation; PROPERTY DEVELOPMENT AND RESEARCH COMPANY, a Minnesota corporation; and 2361 BUILDING CORPORATION, a Minnesota corporation,

Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF AMICUS CURIAE OF HON INDUSTRIES, INC.

Lowell E. Sachnoff*
William Gleeson
Sarah R. Wolff
SACHNOFF WEAVER & RUBENSTEIN, LTD.
Suite 2900
30 South Wacker Drive
Chicago, Illinois 60606
(312) 207-6468
*Attorney of Record

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This brief is in support of the petitioner. It is filed with the consent of all of the parties.

INTEREST OF HON INDUSTRIES, INC.

HON INDUSTRIES, INC. has an interest in this case in that it is a plaintiff in an action pending in the U.S. District Court, Southern District of Ohio, Western Division (Civil Action C-1-83-793). That case involves allegations of fraud in the sale of tax shelter securities and seeks damages under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. An important issue in the resolution of that case is whether a damage award should be reduced by tax benefits received by an investor, which is precisely the same issue to be decided in this case.

SUMMARY

The primary function of the fraud remedies of Section 12(2) of the Securities Act of 1933 (the "Securities Act") and Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5 thereunder is to deter persons from violations of the full and fair disclosure provisions of the securities laws. Assuring that investors who have been defrauded is also a goal, but only a secondary one.

This case involves a situation where damages calculated on a basis which would deter violations (whereby damages are not reduced by tax benefits) would yield more than damages calculated on a basis to compensate the investor (whereby damages are reduced by tax benefits)

and arguably the damage award which implements a deterrence theory more than compensates the investor for his loss.

Where there is a choice between damage theories, the one which implements the more important goal should be chosen. Here, the goal of deterrence is more important and tax benefits should not reduce damages.

While a damage theory based upon deterrence is not without limit, the one limitation which might be pertinent here is not applicable because of fact differences. That limitation allows a fraudulent party to reduce his damages to the extent that he can show that after the fraud he created extraordinary gains as a result of his special efforts. It is not applicable here because the benefits which the seller now wishes to take credit for were foreseen and

the seller's[1] efforts resulted in foreclosure, not extraordinary gain.

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[1] In this brief, the defendant Loftsgaarden is sometimes referred to as the seller. It should be noted that the term seller is also sometimes used generically.

ARGUMENT

INTRODUCTION

The Court of Appeals decided that the tax benefits which an investor receives as a result of his investment in a tax shelter security must reduce the amount of the damages the investor would otherwise receive under the fraud remedies of Section 12(2) of the Securities Act and Rule 10b-5 under the Exchange Act. That decision was based on the view that the "nature of damages in private securities fraud actions" is "strictly compensatory" and that damages are limited by the "extent [to which] damages are inflicted on the plaintiffs."[2]

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[2] J.A. A-11

We believe that the fraud remedies of Section 12(2) and Rule 10b-5 are not "strictly compensatory." While compensating defrauded investors is certainly one of the functions of the fraud remedies, it is not the primary function. Deterring sellers from violating the disclosure provisions of the two Acts is the function which is primary; and reducing a damage award by tax benefits conflicts with, and seriously undermines, that function. We believe that in order to implement the goal of deterrence, tax benefits should be ignored.

TWO IMPORTANT ASPECTS OF THE TAX LOSSES

By way of introduction to the argument below, we want to note two facts about the tax losses generated by the partnership here, facts which we believe

are important to the argument.

First, the tax losses were foreseeable by the seller at the time he fraudulently sold the securities. The seller had, in fact, projected some of the tax losses and had included these projected tax losses in the private placement memorandum distributed to investors.[3] More importantly, the seller was able to project most or all of the additional losses; that is, the losses which were not projected in the private placement memorandum but which were incurred and which led to foreclosure. For example, one of the main reasons for losses was the interest rate on the construction loan. The seller had projected the

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[3] J.A. D-7

interest rate to be 9.5%, but the seller knew it would exceed 9.5% (because the rate floated 4% above prime and at the time the securities were sold, prime was already in excess of 7%).[4] As a result, the seller could foresee most of the losses which were incurred by the partnership, losses he now wants to use to reduce the amount of damages he must pay.

Second, the tax losses which the seller now wants to take advantage of did not flow from any meritorious efforts or talents of the seller. Most of the tax losses which had been projected by the seller in the private placement memoranda resulted from depreciation and interest deductions, which are

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[4] J.A. E-2, E-3, E-4

passive-type deductions which do not result from the seller's efforts and are available in all instances where, as the case may be, the property is owned or it is acquired by debt financing. Most of the additional losses resulted primarily from the fact that the project operated at a real cash loss. Indeed, the operating losses were far greater than projected in the private placement memorandum. These cash losses from operations translated directly on a dollar-for-dollar basis into tax losses.

THE OVERALL GOAL OF FEDERAL SECURITIES LAWS IS FULL AND FAIR DISCLOSURE

In deciding whether tax benefits should reduce a damage award, this Court should be guided primarily by considera-

tions of the policies underlying the Federal securities laws in general and the fraud remedies in particular because the language of the two statutes insofar as they relate to damages is not particularly helpful. Section 28 of the Exchange Act speaks in terms of "actual damages" without specifying the components of damages. Section 12(2) is more specific with its "less. . . income" language, but perhaps not more helpful since it is certainly possible to construe the term "income" narrowly (to include only dividends, distributions and proceeds of resale) or broadly (to also include tax benefits).

What follows is a very brief discussion of the general purpose of Federal securities laws. While we do not think that there can be any serious disagreement about that purpose, we feel that

the discussion is useful because it puts the fraud remedies of Section 12(2) and Rule 10b-5 in context, and suggests the policies which the fraud remedies are intended to implement.

A review of the legislative histories of the Securities Act and the Exchange Act indicates that the general purpose of the Federal securities laws is to assure that investors are provided with accurate and adequate information, which they can use to make informed investment decisions.

For example, the Senate Report on the Securities Act indicates that Congress believed that providing accurate disclosure to investors was the primary purpose of the Act and that such disclosure would lead to efficient functioning of the securities market and to rational allocation of capital resources.

The Report said:

> The aim [of the Act] is to. . . place adequate and true information before the investor. . . [in order] to restore the confidence of the prospective investor in his ability to select sound securities [and] to bring into productive channels of industry and development capital which has grown timid to the point of hoarding.

S.Rep. No. 47, 73rd Cong. 1st Sess. 1 (1933) (accompanying S. 875)

THE FUNCTION OF THE FRAUD REMEDIES IS DETERRENCE

The primary function of the fraud remedies of Section 12(2) and Rule 10b-5 is to further the general purpose of the securities laws; that is, their function is to promote full and fair disclosure. The fraud remedies do this by imposing a measure of damages which

is sufficiently burdensome on potential sellers that sellers will choose to comply with the disclosure requirements rather than risk paying the damages required by the fraud remedy. Put more succinctly, the fraud remedies of Section 12(2) and Rule 10b-5 function by deterring violations.

The importance of detering violations cannot be overemphasized: investors need accurate and adequate information in order to make informed choices; and capital will be allocated efficiently in the markets only if investors are able to make informed choices. Generally speaking, a market will be efficient only if it matches projects, sellers and funds until, at the margin, returns

are equal.[5] If the fraud remedies do not deter potential violators, dishonest and incompetent sellers of securities will be able to make the same representations about the quality of, and potential return from, their securities as honest and competent sellers make about theirs. Because verification by investors of the statements made by sellers is costly, at best difficult and usually does not occur, the effect of fraud will be that investors will not be able to distinguish between low quality and high quality securities. As a result, some funds will flow into lower quality investments.

We want to be careful, however,

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[5] Easterbrook and Fischel, Mandatory Disclosure and the Protection of Investors, 70 U.Va. L.R. 669, 673 (1984)

to note that while we say that the primary function of the fraud remedies is deterrence, we do not say that the compensation of investors who have been defrauded is not also a function. Compensation is a function, but a secondary one. It is secondary because the act of compensating investors who have lost money as a result of fraud does not in and of itself promote the general purpose of providing accurate and adequate information. The compensatory aspect of the fraud remedy comes into play only if the deterrence factor has failed. In effect, the compensatory aspect of the fraud remedies merely redresses a wrong already committed when the seller sold securities without full and fair disclosure. At that point in time, it is too late to be concerned with how to make sellers provide accurate informa-

tion.

Accordingly, when damage remedies are being shaped, the remedies should be designed so that, within the boundaries set by the statutory language, the remedies will best accomplish their primary function of promoting full and fair disclosure; that is, the fraud remedies should be shaped so that they function in a manner that they will deter violations.

A look at the legislative history is useful at this point. The legislative history supports the views that Congress, in developing the fraud remedies, was focusing on deterring violations, not on compensating investors; that Congress wanted the fraud remedies to have impact on sellers of securities at the time those sellers were deciding what and how much to disclose; and that the impact

would have the effect of deterring violations. For example, the House Report on the Securities Act makes clear that the function of the civil liabilities in Section 12(2) is to deter violations. The theory is that the threat of harsh remedies would affect the conduct of those who sell securities and cause them to make full disclosure.

> The character of civil liabilities imposed by this bill. . . consists of a requirement that all of those responsible for statements upon the face of which the public is solicited to invest its money shall be held to standards like those imposed by law upon a fiduciary. . . If it be said that the imposition of such responsibilities upon these persons will be to alter the corporate organization and corporate practice in this country, such a result is only what your committee expects.

H.R.Rep. No. 85, 73d Cong., 1st Sess.5 (1933) (accompanying H.R. 5480), at 5 (emphasis supplied)

This Court has acknowledged that the primary function of the fraud remedies was to assure that investors were provided with accurate information. In TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 448 (1976), the Court discussed Rule 14a-9, which is the fraud remedy under the proxy provisions of the Exchange Act and said that the "broad remedial purpose" of the fraud remedy was "to ensure disclosures. . . in order to enable shareholders to make an informed choice." While TSC did not deal with the issue of the relative importance of deterrence and compensation, we believe that implicit in a statement that the function of a fraud remedy is ensuring accurate disclosures is the idea that compensation would be only a secondary function of the remedy.

Although this Court has not directly discussed the relative importance of the deterrence and compensation functions of the fraud remedies, lower courts have, and have held that the primary purpose is deterrence. In Globus v. Law Research Service, 418 F.2d 1276, 1288 (2nd Cir. 1969), cert. denied 397 U.S. 913 (1970), the Second Circuit said:

> Civil liability under [the Securities Act] was designed not so much to compensate the defrauded purchaser as to promote enforcement of the Act and to deter negligence by providing a penalty for those who fail in their duties.

418 F.2d at 1288

Similarly, in Feit v. Leasco Data Processing Equipment Corporation, 332 F.Supp. 544, 567 (E.D. N.Y. 1971) the Court said:

> The principal purpose of civil liability in the 1933 Act is, in fact, deterrent rather than compensatory.

332 F.Supp. at 567

A DAMAGE REMEDY WHICH FURTHERS DETERRENCE SHOULD BE CHOSEN OVER ONE WHICH MERELY COMPENSATES VICTIMS

The issue of whether deterrence is the primary function of the fraud remedies becomes important only when the measure of damages calculated under a deterrence theory differs from that calculated under a compensation theory. Most certainly, logic would dictate that if the primary function of the fraud remedies is to deter violations, the remedy which best accomplishes that function while staying within the boundaries imposed by the statutory language should be chosen. Moreover,

it is, of course, a basic rule of statutory interpretation that a statute should be construed to achieve its purposes. In United Housing Foundation v. Forman, 421 U.S. 837, 849 (1975) this Court said that interpreting the Securities Act and the Exchange Act involved a process of "construing these Acts against a background of their purpose."

We have found no case where this Court dealt with the issue of which damage remedy to choose where one damage remedy is based on a theory of deterrence and the other on compensation. But this Court has dealt with a similar issue. In Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128 (1972), the Court indicated which damage remedy it would choose as between one which imple-

mented a policy which would compensate the victim and one which implemented a policy which would prevent unjust enrichment of the fraudulent party. The remedy which would prevent unjust enrichment would more than compensate the victim for his loss. Nevertheless, it was the one to be selected. Affiliated Ute involved a defrauded seller of securities, and this Court indicated that the usual measure of damages in a securities fraud action is the out-of-pocket measure. However, this Court said that the usual rule does not apply in a situation where the out-of-pocket measure would unjustly enrich the fraudulent party.

> Where the defendant has received more than the seller's actual loss. . . damages are in the amount of seller's profit.

id. at 155

Although the Court did not elaborate on this statement, nevertheless we believe that the Court's language fully supports four related propositions.

First, any damage remedy should focus on the impact of the remedy on the fraudulent party. Janagin v. Taylor, 344 F.2d 781 (1st Cir. 1965) cert. denied 382 U.S. 879 (1965), which was cited with approval in Affiliated Ute, involved the same fact situation as Affiliated Ute (i.e. the purchaser of securities committed the fraud). The First Circuit, in shaping a damage remedy, focused on the impact on the wrongdoer: "it is simple equity that a wrongdoer should disgorge his fraudulent enrichment." id at 786

Second, full compensation of an investor's loss does not set an outer

limit on the damages which can be awarded under the securities laws.

Third, when damages calculated on a theory which implements a policy of compensating the investor are less than damages calculated on a theory which implements another, more important policy, the damages remedy which furthers the other more important policy should be chosen.

Fourth, a damage remedy which awards a victim more than his out-of-pocket loss in order to vindicate a more important policy does not conflict with the language of the statutes relating to the amount of damages (Section 28 of the Exchange Act -- "actual damages;" Section 12(2) -- "consideration paid. . . less the amount of income." Thus, the remedy stays within the boundaries set

by the statutory language.

REDUCING A DAMAGE AWARD BY TAX BENEFITS SERIOUSLY UNDERMINES DETERRENCE

Because it is clear that the remedy which best implements deterrence should be chosen, it is necessary to look at the two available remedies (one which reduces the award by tax benefits, the other which does not) to determine which more effectively furthers the policy of deterrence.

In order to understand how a damage remedy implements a policy of deterrence it is necessary to understand two aspects of deterrence.

First, in order to determine the deterrent force fo a particular remedy, it is necessary to understand how the damage remedy impacts the seller who commits the fraud. (How the remedy

affects the investor is not relevant to an inquiry about deterrence.)

Second, the way to determine the deterrent force of any particular damage remedy is to measure the difference between how the remedy treats those who obey and those who disobey. Obviously, the smaller the difference, the less the deterrent force of the damage remedy. And if the difference is small, the damage remedy will not deter potential violators at all. That is, if the damage remedy reduces the difference between complying and not complying to a point where it is not significant, and if there are likely to be gains from violating the law (i.e. if misrepresenting the facts will make it easier to sell the securities), then one may as well violate

the law and make the misrepresentations.[6]

Reducing damage awards by the amount of tax benefits which an investor receives necessarily reduces the deterrent force of the fraud remedies; in some cases, completely eliminates it. This is because the tax benefits (which reduce the amount the fraudulent seller must pay) are not out-of-pocket costs to the seller; they cost the seller nothing. This diminution in deterrent force is created by the fact that the tax losses are foreseeable by the seller at the time the securities are sold.

For example, if the seller of securities were selling tax shelter securities where the tax benefits flow

[6]See Easterbrook and Fischel, supra, at 684

directly through to the investor, the seller would realize that because of the tax benefits, he would never have to repay all of the money he obtained through his fraud. And this seller would also realize that if the shelter were deep enough (that is, if it provided sufficiently large tax losses), he might have to pay back only a small fraction of what he obtained by fraud, or perhaps nothing at all. This seller can reasonably ask himself: why not misrepresent the facts if doing so helps to sell the securities? If he is sued, the worst that can happen is that he would have to give back only part of what he obtained by fraud; and sometimes, he will not have to give back anything at all. So, from his point of view, why not commit fraud?

We believe that a damage remedy which allows tax benefits to be deducted from the damage award conflicts with the goal of deterrence which underlies the fraud remedies of Section 12(2) and Rule 10b-5 and should not be allowed.

THE SELLER'S EFFORTS IN PRODUCING TAX LOSSES ARE NOT OF THE TYPE WHICH JUSTIFY REDUCING DAMAGES AS A RESULT OF SUCH LOSSES

We recognize that a theory of damages based upon deterrence is not

without limits. Under certain circumstances, a damage award will be reduced even though deterrence is the primary function of the damage remedy.

Pertinent here are the cases which involve the same fact situation as Affiliated Ute. Those cases involve fraud by a buyer of securities. After the fraudulent transaction, the value of the securities increases while the buyer holds them. The increase was not foreseeable at the time of the transaction. The victim sues to recover not only his out-of-pocket loss (i.e., difference between the real value of the securities at the time of sale and the sale price), but also the unforeseen increase in value after the sale. The fraudulent buyer does not contest that he owes the victim the out-of-pocket cost. But he argues that he should not pay some or all of

the increase in value which occurred after the sale because the fraudulent buyer was responsible for the increase. Typically, he claims that he is responsible because he managed the business in question and did so efficiently, thereby enhancing the value of the securities. The fraudulent buyer claims that the victim should not get the benefit of what the buyer's efforts have produced.

These cases are relevant here because in this case the seller argues that he has provided the tax losses to the investors; and that the investor should not get the benefit of what the seller has produced. (The investor here, of course, will keep the tax losses, but would lose the benefit of them if the tax losses are used to reduce damages.)

Case law, however, makes clear that a fraudulent buyer can reduce damages as a result of benefits he produces only if the fraudulent party can show the benefits resulted from "extraordinary gain" resulting from "special efforts." The cases hold the fraudulent buyer need not pay as damages any increase in value which can be attributed to his "aggressive and enterprising management ability" Rochez Bros. Inc. v. Rhodes, 491 F.2d 402, 412 (3rd Cir., 1974). He cannot reduce the damages even though he managed the business if "no extra-ordinary gains are attributable" to him and he merely "received his salary for his personal efforts which would have been his regular duty." Janigan v. Taylor, supra, 786

While it is sound policy to allow

a defendant to reduce his damages to the extent that he can show that his extraordinary gain produced by his special efforts, that policy is not applicable to this case in which the fraudulent party produced tax losses. There are four reasons for this result.

First, in this case the seller did not cause any "increase in value;" rather he caused losses; he managed the project so badly that it was ultimately lost to foreclosure.

Second, it was undoubtedly the case here as it is in a typical tax shelter that tax losses, in large part, resulted from interest and/or depreciation deductions, two items which do not involve the seller's efforts and which are available in every situation where property is owned and is acquired, in

whole or in part, for debt. (In any case, these are deductions intended to reflect real economic costs incurred by the investor; they are not gains, much less "extraordinary gains.")

Third, it was undoubtedly true here as it is in most tax shelters which fail that most of the tax losses in addition to those generated by interest and depreciation, resulted from the fact that the business of the tax shelter being operated poorly at a level below breakeven operations. The cash losses from operations translate directly into tax losses. If the test which allows a fraudulent party to reduce damages is "aggressive and enterprising management ability," then managing a business so that it loses money, and thereby generates tax losses, most certainly

should not satisfy. And again, these taxes reflect real economic costs incurred by the investors and do not represent "extraordinary gain."

Fourth, the tax losses in this case were specifically foreseeable. By contrast the "extraordinary gain" generated by the "special efforts" of the fraudulent party after the fraudulent transaction had been completed were not foreseeable.

Accordingly, the seller's efforts in this case are not of the type which would allow the tax losses to reduce a damage award.[6]

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[6]Another limitation on the amount of damages which may be awarded on a deterrence theory relates to dividends or distributions which are in effect a return of the investor's capital. But no cash distributions or dividends were made in this case and thus this doctrine is not relevant here. In any case, the Court of Appeals correctly noted that tax losses should not be treated as a return of capital. (J.A. A-18)

ALLOWING TAX LOSSES TO REDUCE A DAMAGE AWARD WILL REWARD FRAUD

Securities fraud actions usually arise in the context of a situation where the fraudulent seller makes misrepresentations as to the financial viability of the project. Typically, the project operates poorly and it is the very facts which were misrepresented or omitted which cause the poor operational results. (In this case, the fraudulent seller represented that the construction loan would bear a fixed rate of interest at 9½%. In fact, the interest rate floated at 4% above prime. The project encountered financial difficulties in large part because of excessive interest costs

as a result of the floating rate loan.)[7] Because the project operates at a loss on a cash basis, tax losses passed through to investors are greater than projected. These larger than expected losses are directly related to the seller's fraud.

If the tax losses are used to reduce the damage award, the seller in effect becomes the beneficiary of his own fraud. The larger the fraud, the larger the tax losses; and the larger tax losses, the less the seller must pay out of his own pocket in damages. Ironically, the ultimate effect or reducing a damage award by tax benefits would be to reward the fraud.

---

[7] J.A. D-9

ADVERSE EFFECTS OF A RULE WHICH REDUCES A DAMAGE AWARD BY TAX BENEFITS

One of the problems created by a damage formulation which erodes the deterrent effect of the fraud remedies is that it leads to misallocation of capital. If there is little or no deterrent force to the fraud remedy, dishonest sellers will misrepresent facts and make false claims. This will lead to investment based on inaccurate and inadequate information and investors' funds will flow to dishonest promotors. One of the effects which Congress intended when it decided to require that investors be given accurate and adequate information was that capital would be allocated efficiently and the allocation process would not be distorted by false

and misleading disclosures. The Senate Report on the Securities Act indicated that an "aim [of the bill] is to protect honest promotors, seeking capital by honest presentation, from the competition afforded by dishonest securities offered to the ...blic through dishonest promotion." S.Rep. 47, 73d Cong. 1st Sess. 1 (1933) (accompanying S. 875).

The problem of misallocation is exacerbated by the fact that a remedy which reduces the damage award by tax benefits is limited to one area of the securities market. Outside of the tax shelter securities area, tax benefits do not reduce the amount of the award. It should necessarily follow that fraudulent sellers of securities will seek to sell more and more tax shelter

securities, since their exposure will be less if they sell those rather than other securities.

A COMMENT ON THE COLLATERAL SOURCE RULE

In this brief, we have focused on the policy considerations which are expressed in the legislative history of and the cases construing the Securities Act and the Exchange Act. We have not focused on the collateral source rule, because we believe that resort to that rule is unnecessary. We believe that the policies underlying Federal securities laws make clear that the seller should not be given credit for the tax benefits which an investor recovers. And this is true even though

the seller has produced the tax losses which give rise to those tax benefits.

However, the considerations underlying the collateral source rule are essentially the same as those that we have suggested above in our argument. As a result, if this case we analyzed in terms of the collateral source rule, the result should be the same as the result we suggest above.

In this connection, as a preliminary matter, it should be noted that the case law dealing with the collateral source rule does not apply mechanical distinctions in order to determine whether a source is collateral. In deciding whether a source is collateral, the courts look to policy considerations. See, for example, Haughton v. Blackships, Inc., 462 F.2d 788, 790 (3rd Cir. 1972) where

the court said: "Application of the collateral source rule depends less on the source of the funds than upon the character of the benefits received."

One of the policies which the collateral source rule is designed to implement is the goal of deterring violations. Restatement of Torts, Second, §§901 and 920A (1965).

Another policy implemented by the collateral source rule is related to and in a sense is part of deterrence. It is the policy of making sure that the wrongdoer bears the responsibility for paying the victim. He can do this by paying the victim directly or by having his insurance company do so (in effect he actually pays the victim indirectly by paying his insurance premium). But he is not deemed to have

shouldered the responsibility if the victim's insurance pays or if the government, as a result of social welfare legislation, pays. In effect, the collateral source doctrine requires that the payment to the victim have an impact on the defendant. See Restatement of Torts, Second §920A (1965).

These policies of deterrence and impact on the wrongdoer are essentially the same policies as those which underly the argument above and they lead to the same conclusion. If this case were analyzed in terms of the collateral source rule, policy considerations would require that tax benefits be considered collateral and hence ignored.

CONCLUSION

Tax benefits should not reduce damage awards under Section 12(2) or Rule 10b-5. The decision of the Court of Appeals should be reversed.

Dated: January 4, 1986

Respectfully Submitted,

Lowell E. Sachnoff
Counsel of Record
William Gleeson
Sarah R. Wolff
SACHNOFF WEAVER &
RUBENSTEIN, LTD.
30 South Wacker Drive
Chicago, Illinois 60606
Attorneys for Amicus Curiae
HON INDUSTRIES, INC.

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CHARLES FRIED
Solicitor General

ROGER M. OLSEN
Acting Assistant Attorney General

LAWRENCE G. WALLACE
Deputy Solicitor General

ALBERT G. LAUBER, JR.
Assistant to the Solicitor General

ANN BELANGER DURNEY
TERESA E. MCLAUGHLIN
Attorneys

Department of Justice
Washington, D.C. 20530
(202) 633-2217

DANIEL L. GOELZER
General Counsel

PAUL GONSON
Solicitor

JACOB H. STILLMAN
Associate General Counsel

RICHARD A. KIRBY
Assistant General Counsel

MARTHA H. MCNEELY
CATHERINE T. DIXON
Attorneys
Securities and Exchange Commission
Washington, D.C. 20549

BEST AVAILABLE COPY

QUESTION PRESENTED

Whether, in an action under the federal securities laws for fraud committed in the sale of a security in the form of a tax-shelter investment, the defendant is entitled to reduce the amount of the plaintiff's recovery by tax benefits allegedly realized by the plaintiff on account of that investment.

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BRIEF FOR THE UNITED STATES AND THE SECURITIES AND EXCHANGE COMMISSION AS AMICI CURIAE IN SUPPORT OF PETITIONERS

INTEREST OF AMICI CURIAE

The Securities and Exchange Commission is responsible for administering and enforcing the federal securities laws. A major purpose of those laws is to protect investors from fraudulent practices by promoters in the offer and sale of securities. Although most tax-shelter securities are sold in private offerings exempt from the registration requirements of the Securities Act of 1933, they are subject to the antifraud provisions both of that Act and of the Securities Exchange Act of 1934.

In a recent year, about two-thirds of the 15,000 private offerings made under SEC Regulation D, 17 C.F.R. 230.501 *et seq.*, were limited-partnership, and thus presumably tax-shelter, ventures. SEC Directorate of Economic and Policy Analysis, *An Analysis of Regulation D*, at i-ii (May 1984). Given this volume of offerings, the SEC lacks the resources to ensure that fraud in the offer or sale of tax-shelter investments will be detected and

prosecuted. Private damage actions under the federal securities laws are thus a necessary supplement to the Commission's enforcement activities. *Bateman Eichler, Hill Richards, Inc.* v. *Berner*, No. 84-679 (June 11, 1985), slip op. 10, 16-18.

The tax-offset rule adopted by the court of appeals contravenes the policies and purposes of both the securities laws and the tax laws. It undermines the deterrent purposes of private securities actions by allowing a defrauding seller to retain proceeds that he has illegally obtained from his victim, and may often deter the victim from bringing suit at all. And its effect is to make the government, the source of the buyer's tax benefits, subsidize the seller's fraud, thus granting a windfall to the wrongdoer at the expense of taxpayers generally. At this Court's invitation, the United States filed a brief in *Salcer* v. *Envicon Equities Corp.*, petition for cert. pending, No. 84-1447, urging that certiorari be granted in the present case.

STATEMENT

1. Petitioners are purchasers of interests in a real estate limited partnership organized to construct, own and operate a Ramada Inn in Rochester, Minnesota (Pet. App. A3). Respondents are the promoter of the project and three of his closely-held corporations. One of the corporations owned the land on which the hotel was to be built, another served as the general contractor, the third as general partner (*id.* at D1-D4).

The partnership was marketed as a "tax shelter." Its offering memorandum represented that the limited partners would realize income tax savings as a result of losses expected to be incurred during the partnership's first three years, and that the limited partners would thereafter share in the venture's expected profits (Pet. App. A3). Petitioners purchased their interests in 1973 at a cost of $35,000 per unit (*id.* at D1, D7 n.8).

The Ramada Inn opened in 1974, several months behind schedule, and at a construction cost substantially in excess of that projected (Pet. App. A3). The hotel subse-

quently incurred sizable losses due to higher-than-budgeted operating expenses and lower-than-predicted occupancy rates (*id.* at D9). The partnership ultimately defaulted on its obligations, and foreclosure by its creditors ensued in 1978 (*id.* at A3, D10).

In June 1976, petitioners brought this securities fraud action in the United States District Court for the District of Minnesota, seeking recovery under Section 12(2) of the Securities Act of 1933, 15 U.S.C. 77*l*(2), Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and SEC Rule 10b-5, 17 C.F.R. 240.10b-5. After a seven-day trial, the jury found that respondents had violated Section 10(b) and Rule 10b-5 by knowingly making material misrepresentations and omissions in the offering memorandum upon which petitioners had relied, thereby causing injury to petitioners. The jury also rendered an advisory verdict, adopted by the district court, finding that respondents were likewise liable for their fraud under Section 12(2) (Pet. App. A4).

The district court found that petitioners' investments had become worthless by the time they learned of the fraud (Pet. App. E15). It awarded them rescissionary damages under Section 12(2) in the amount of the purchase price that each had originally paid, plus prejudgment interest (*id.* at E15, E16, F15). The court noted (*id.* at E16) that petitioners' Section 10(b) claim "independently support[ed]" a grant of relief, but that their recovery under Section 10(b) would be no greater than under Section 12(2). The court rejected, as "sophistic malarkey," respondents' contention that petitioners' damages should be reduced by the amount of tax benefits that they had assertedly received (*id.* at F8).

2. The court of appeals sustained the district court's determination that respondents were liable under Sections 10(b) and 12(2) (Pet. App. D11-D18). It concluded that "misrepresentations so permeated" the offering memorandum as to render the memorandum's forecasts and projections unreasonable and misleading (*id.* at D5, D14). The court of appeals also upheld the jury's

finding that respondent Loftsgaarden had understated by more than 50% the compensation that his closely-held corporations were to receive for their roles in the venture (*id.* at D9).

The court of appeals reversed the district court's award of damages, however, and remanded for a new trial on that issue (Pet. App. D20-D28). It held that petitioners' recovery, under either Section 10(b) or Section 12(2), had to be reduced by the amount of any tax benefits that their investment had generated. The court noted (Pet. App. D20) that a plaintiff's recovery under Section 10(b) cannot be "in excess of his actual damages on account of the act complained of" (15 U.S.C. 78bb(a)). "The actual damages principle," the court said, "requires that a rescissional or restitutional award be reduced by any value received as a result of the fraudulent transaction," and the court concluded that petitioners' tax deductions constituted "value received as a result of" their tax-shelter investment (Pet. App. D21 (original quotation marks omitted)). The court of appeals further noted (*id.* at D21-D22) that Section 12(2) permits a defrauded investor "to recover the consideration paid for [the] security with interest thereon, less the amount of any income received thereon" (15 U.S.C. 77*l*(2)). Since petitioners' tax deductions served to reduce their taxable income, the court reasoned, those deductions were essentially the equivalent of "income received."

Noting that petitioners' tax returns for 1973-1978 were then "undergoing audits by the Internal Revenue Service," the court of appeals acknowledged that the damages formula it mandated was not "entirely devoid of speculation" (Pet. App. D27). "[T]he possibility that past tax deductions will be disallowed," the court said, was "[c]ertainly * * * relevant to the determination" of petitioners' damages (*ibid.*). The court ruled that "[e]vidence of the audit and expert opinions as to its likely results [should be] admissible at the retrial on damages," with "[t]he jury [being] entitled to determine whether and to what extent there would be a disallowance of deductions" (*ibid.*).

3. On remand, the district court accepted respondents' calculation of petitioners' tax benefits (Pet. App. C2-C4). These calculations were based on petitioners' federal and state income tax returns for 1973-1978, and on a report prepared by an IRS revenue agent, upon conclusion of the audit, reflecting petitioners' agreement to recognize a certain amount of income as a result of the hotel's foreclosure in 1978 (C.A. App. A138, A153-A154). The district court then calculated each petitioner's damages as the amount he had paid for his investment, plus 8% simple interest from the date of his purchase, minus the amount of his net tax benefits (Pet. App. B1-B3).

4. On cross-appeals from the district court's judgment, the court of appeals ordered reconsideration en banc. As to the propriety of the tax-offset rule, the court adhered to the original panel opinion. It held that the receipt of tax benefits negates pro tanto a plaintiff's "actual damages," and it held that the "actual damages" limitation applicable to recoveries under Section 10(b) of the 1934 Act likewise applies to computations of restitutionary awards under Section 12(2) of the 1933 Act (Pet. App. A6-A8). While acknowledging that tax benefits are not "a form of income in a strict accounting sense," the court expressed the view that "section 12(2)'s requirement that 'income received' be deducted in determining rescissionary damages simply reflect[s] that all economic benefits bargained for and received must be deducted" in computing damages (Pet. App. A11 (footnote omitted)). The court accordingly held that the words "income received" as used in Section 12(2) "should be construed as including the tax benefits bargained for and received in the special case of a tax shelter investment" (Pet. App. A8).

The court then adopted an elaborate formula for computing recoveries under Section 12(2) in light of the tax-offset rule. It began by accepting the district court's calculation of the "permanent tax benefits" that each petitioner had received (Pet. App. A15). It agreed with the district court that petitioners were entitled to prejudg-

ment interest on their rescinded investment, but reasoned that, "[b]ecause [they] were not deprived of the use of the entire amount of their investments over the ten year period, prejudgment interest is due only on the amount of money they were out-of-pocket at any given time" (*id.* at A20). The court hence subtracted from petitioners' original investment the tax benefits that they had received each year, and then calculated prejudgment interest based on that annually-declining balance (*id.* at A21). For years in which petitioners' cumulative tax benefits exceeded their original investment, petitioners in effect were required to pay prejudgment interest to respondents (*ibid.*).

The court next held that it was necessary to take into account, not only the tax savings that petitioners had previously enjoyed, but also the tax consequences of any securities-fraud recovery that they might receive herein. The court "assume[d] that each [petitioner was] still in the fifty percent tax bracket," and it assumed that each petitioner's recovery would be taxed to him in full as ordinary income rather than as capital gains (Pet. App. A22). Concluding that each petitioner therefore "must receive twice the [previously-computed] damages and net interest cost" in order to make his after-tax recovery equal to his "actual damages," the court doubled the figure previously computed (*ibid.*). The court of appeals held, in other words, that the measure of rescissionary damages prescribed by Section 12(2) is the plaintiff's original investment, minus his tax benefits, plus prejudgment interest on his original investment, minus prejudgment interest on his tax benefits, times two (*ibid.*).[1]

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[1] The result of applying the tax-offset rule was to reduce considerably each petitioner's damages award compared to what it would otherwise have been. For example, apart from any consideration of tax benefits, petitioner Randall under the district court's computation would have been entitled to a total recovery of $67,973 (Pet. App. B1-B2). Under the court of appeals' holding Randall's recovery was $506 (*id.* at A22). Petitioner Neumann's recovery was simi-

Chief Judge Lay, joined by Judge Bright, dissented (Pet. App. A25-A30). They contended that the majority's treatment of tax benefits as "income received" for purposes of Section 12(2) conflicted with "the clear language of the statute" (Pet. App. A26-A27). They argued that a plaintiff's alleged tax benefits should have no role in determining his securities-fraud recovery, since "[t]he tax transaction is between [the plaintiff] and the government and should not affect [the defendant's] liability" (*id.* at A29). And they argued that the majority's tax-offset rule improperly allows a defendant "to escape liability, shifting the burden of the loss onto the government" (*id.* at A30).

SUMMARY OF ARGUMENT

The court of appeals' decision is wrong as a matter of securities law, tax law and common sense. The tax-offset rule cannot be squared with the language of Section 12(2), which permits a rescinding buyer to recover the consideration paid for his security, "less the amount of any income received thereon." Tax deductions and credits provided by the Internal Revenue Code are not "income received * * * on" a partnership investment.

This plain-language reading is confirmed by principles governing the common-law remedies of rescission and restitution, which Section 12(2) codifies. The common law required the rescinding buyer to restore to the seller the contested property plus its "direct product," that is, those benefits derived immediately from the property without the intervention of any independent act by the buyer. Because tax deductions and credits are derived from the Internal Revenue Code, not from the investment property, and because they require independent acts of the taxpayer (including generation of income) before they can come into existence, they are not a "direct product" of

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larly reduced from $96,385 to $1,984; petitioner Austin's from $64,610 to $7,666; and petitioner Anderson's from $64,787 to $18,790. Compare *id.* at B1-B2 with *id.* at A22.

the rescinded investment requiring "restoration" to the fraudulent seller.

In adopting its tax-offset rule, the court of appeals also took an unduly narrow view of the "actual damages" principle as applied to recoveries under Section 10(b). That principle permits a plaintiff to recover an amount in excess of his actual economic loss where necessary to prevent the defendant's unjust enrichment. If a plaintiff were ultimately to realize any net tax benefits from the rescinded transaction, it would unjustly enrich the defendant to transfer those savings to him via the tax-offset rule. As between the investor and the promoter who defrauded him, the investor is plainly more equitably situated to retain this species of publicly-funded largesse, not only because he is the victim rather than the perpetrator of fraud, but also because he is the person upon whom Congress conferred the tax benefits to begin with.

The tax-offset rule is also wrong as a matter of tax law. In appraising a plaintiff's aggregate tax benefits, one must consider, not only the tax benefits previously claimed, but also the tax consequences of his securities-fraud recovery. The Internal Revenue Code has intricate mechanisms that require the offset or "recapture" of previously-claimed tax benefits upon receipt of a damages award. This Court accordingly held in *Hanover Shoe, Inc.* v. *United Shoe Machinery Co.*, 392 U.S. 481 (1968), that an award of damages must be based on the plaintiff's *pre-tax* loss where the award itself will be taxed. The rationale of that decision applies equally here.

Finally, the tax-offset rule would seriously compromise the deterrent value of private actions in enforcing the securities laws. In reducing or eliminating the damages recoverable by plaintiffs defrauded in tax-shelter schemes, it would lessen the incentives for promoters to comply with the law by permitting wrongdoers to retain the fruits of their fraud.

ARGUMENT

WHERE A DEFRAUDED PURCHASER OBTAINS RESCISSION OF HIS SECURITIES TRANSACTION UNDER THE FEDERAL SECURITIES LAWS, THE DEFENDANT'S LIABILITY SHOULD NOT BE REDUCED BY THE TAX SAVINGS, IF ANY, REALIZED BY THE PURCHASER ON ACCOUNT OF HIS OWNERSHIP OF THE SECURITY

A. At Common Law, The Restitutionary Recovery Of A Rescinding Purchaser Would Not Be Reduced By His Tax Savings

In deciding what remedies are proper under the federal securities laws, it is often appropriate to begin by considering "the state of the law at the time the legislation was enacted" in order to ascertain "Congress' perception of the law that it was shaping or reshaping." See *Merrill Lynch, Pierce, Fenner & Smith* v. *Curran*, 456 U.S. 353, 378 (1982). It is useful here, in determining the proper measure of restitutionary recovery in actions under Sections 10(b) and 12(2), to start by examining the common-law doctrines of rescission and restitution as applied by the courts contemporaneously with those statutes' enactment. Examination of these doctrines shows that the rationale underlying the court of appeals' tax-offset rule is contrary to the common law.

At common law, a person induced by a false prospectus, report or other promotional document to buy stock could sue the seller for rescission of the transaction and restitution of the consideration paid. See, *e.g.*, *Seneca Wire & Mfg. Co.* v. *A.B. Leach & Co.*, 247 N.Y. 1, 159 N.E. 700 (1928); *Hall* v. *Bank of Baldwin*, 143 Wis. 303, 127 N.W. 1969 (1910); 3 J. Pomeroy, *A Treatise on Equity Jurisprudence* § 881 (5th ed. 1941). Rescission was the act of voiding the original transaction. Restitution implemented the return of property to each party in order to restore, as nearly as possible, the status quo ante. See C. McCormick, *Handbook on the Law of Damages* § 121, at 448 (1935); D. Dobbs, *Handbook on the Law of Remedies* § 4.1 (1973).

Under principles of common-law restitution, the seller was required to surrender the consideration that he had received from the rescinding buyer, together with interest thereon. See Restatement of Restitution §§ 28, 151, 156 (1937); 3 H. Black, *A Treatise on the Rescission of Contracts and Cancellation of Written Instruments* § 632 (2d ed. 1929). In exchange for the return of his consideration, the buyer was required to relinquish the property that he had received from the seller, together with any earnings on that property.[2] If the buyer had sold the security before bringing suit, he could obtain a money judgment approximating his purchase price, plus interest, minus the proceeds of his sale and minus any income that he had earned on the security while he owned it.[3]

In calculating a restitutionary award at common law, the courts uniformly held that the "earnings" with which the defendant was to be credited were those that represented the "direct product" of the buyer's security ownership, such as dividends received on corporate stock or interest paid on corporate bonds. Restatement of Restitution §§ 157, 205 (1937). According to the Restatement (*id.* § 157 comment *b*):

> The phrase "direct product" means that which is derived from the ownership or possession of the property without the intervention of an independent transaction by the possessor.

Credit to the seller, in other words, was limited to return of the property itself (including, in certain circumstances, compensation for depreciation in its value), plus any benefits conferred directly upon the purchaser

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[2] Restatement of Restitution §§ 1, 65, 157(1)(a) (1937); G. Clark, *Equity* 445 (1954); 3 H. Black, *supra*, § 617, at 1495 (citing cases); 2 J. Story, *Equity Jurisprudence* §§ 936-938, 962-966 (1918); 5C A. Jacobs, *Litigation and Practice Under Rule 10b-5*, ¶ 260.03[c][vi], at 11-56 (2d ed. 1985) (discussing common-law doctrines).

[3] Restatement of Restitution §§ 4(f), 66, 150, 157 (1937); D. Dobbs, *supra*, § 9.4, at 622-628. See 2 J. Story, *supra*, §§ 963-965.

by the property (such as income generated by it or the fair market value of its use).[4] It thus followed that a defrauded purchaser at common law was entitled to retain any benefits that originated from a source independent both of the property and of the seller. For example, if a dentist had rendered services at his premises, and if his purchase of that realty were later rescinded, he would not have been required at common law to "restore" to the seller any portion of the fees received for his labor. Those benefits, while related in a way to the property, would obviously not represent the direct and immediate product of its ownership.

The common-law doctrines of rescission and restitution had strong roots in equity. Inherent in the restitutionary remedy was the prevention of either party's unjust enrichment by his retention of property belonging to the other.[5] Where necessary to prevent a wrongdoer's unjust enrichment, moreover, restitution permitted a plaintiff to recover an amount that exceeded his actual economic loss.[6] As between the wrongdoer and his victim, any doubt concerning entitlement to the benefits of a

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[4] See 1 G. Palmer, *The Law of Restitution* §§ 3.12 to 3.14 (1978); 3 H. Black, *supra*, §§ 633-634; Restatement of Restitution § 157 comment *b* (1937) (upon rescinded purchase of realty, seller is entitled to credit for buyer's interim use and occupancy, including rents and compensation for diminution in value). Accord, *e.g.*, *Dieterich* v. *Rice*, 124 Wash. 613, 215 P. 65 (1923) (deduction from buyer's restitutionary award of property's reasonable rental value); *Wright* v. *Dickinson*, 67 Mich. 580, 35 N.W. 164 (1887) (same, value of timber cut from property).

[5] See Restatement of Restitution §§ 1 & comment *e*, 3, 28(c) (1937); 3 J. Pomeroy, *supra*, § 873; D. Dobbs, *supra*, § 4.1, at 224-229; Thompson, *The Measure of Recovery Under Rule 10b-5: A Restitution Alternative to Tort Damages*, 37 Vand. L. Rev. 349, 365-367 (1984) (discussing common-law doctrines); Seavey & Scott, *Restitution*, 54 Law Q. Rev. 29, 29-31 (1938).

[6] Restatement of Restitution § 1 & comment *e* (1937); D. Dobbs, *supra*, at 224, 243-244, 629; Seavey & Scott, *supra*, at 37.

rescinded transaction was resolved at common law in favor of the defrauded party.[7]

These principles of restitution had a counterpart in the common-law tort doctrine generally known as the "collateral sources" rule. Under that rule, a wrongdoer's liability to pay damages was not reduced on account of "[p]ayments made to or benefits conferred on the injured party from other sources," even where such collateral payments "cover[ed] all or part of the harm for which the tortfeasor [was] liable." Restatement (Second) of Torts § 920A(2) & Reporter's Note (1979). See Restatement of Torts §§ 920 comment *e*, 924 comment *c* (1939); D. Dobbs, *supra*, § 8.10. The "collateral sources" doctrine applied, not only in computing recoveries against tortfeasors, but also in calculating certain contract damages, particularly where there had been a fraudulent breach. See *id.* at 185; Fleming, *The Collateral Source Rule and Contract Damages*, 71 Cal. L. Rev. 56, 64 (1983). The doctrine was justified on the ground that "a benefit that is directed to the injured party should not be shifted so as to become a windfall for the tortfeasor," at least where the benefit "did not come from the defendant or a person acting for him." Restatement (Second) of Torts § 920A(2) comment *b* (1979). Like the unjust-enrichment aspects of common-law restitution, the "collateral sources" rule was rooted in principles of fairness. It might in certain situations "permit a double recovery, but it [did] not impose a double burden. The tortfeasor [bore] only the single burden for his

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[7] *E.g.*, *Falk* v. *Hoffman*, 233 N.Y. 199, 135 N.E. 243 (1922) (Cardozo, J.) (defrauded seller of stock permitted to recover not merely the difference between the value of the stock and the amount paid by the defendants, but the proceeds of resale even if such proceeds exceeded its value). See Restatement of Restitution § 3 (1937) ("A person is not permitted to profit by his own wrong at the expense of another."); *id.* §§ 66 & comment *b*, 142 (depreciation in value of property, as between innocent buyer and fraudulent seller, need not be restored to seller); D. Dobbs, *supra*, § 9.4, at 923-925, 928.

wrong." *Gypsum Carrier, Inc.* v. *Handelsman*, 307 F.2d 525, 534 (9th Cir. 1982).

2. The doctrines discussed above, which were current at the time the federal securities laws were enacted, make it clear that a defendant in respondents' position could not have eliminated or reduced, by reference to his victim's tax savings, his liability for fraud at common law. In the language of restitution, such tax savings would not have been deemed the "direct product" of the investment fairly creditable to the defendant's account. Entitlement to tax deductions and credits is conferred, not by the property itself or by its promoter, but by the federal government through the Internal Revenue Code. Since tax benefits do not emanate from the seller or from the property, and since the seller under the tax laws has no claim to these benefits, it makes little sense to say that they should be "restored" to him upon rescission of the transaction.

Moreover, even if tax benefits were thought in some sense to be "derived from the [plaintiff's] ownership or possession of the property," they are not a "direct product" of the investment because they require "the intervention of an independent transaction by the possessor" before they can come into existence. Restatement of Restitution § 157 comment *b* (1937). The right to tax deductions in and of itself has no economic value. What makes tax deductions beneficial is the investor's independent generation of income through his own labor or capital, which in turn enables him to take advantage of deductions made available by the tax-shelter venture. The investor himself in another respect also plays a significant role in generating the tax deductions claimed, since it is his capital contributions, together with those of his co-investors, that give rise to the venture in the first place. While the promoter may have rendered services in connection with the partnership, those services play only a partial and indirect role in securing the plaintiff's tax savings. For all these reasons, a buyer's tax savings would not have been viewed as a "direct product" of his

rescinded investment requiring restoration to the defrauding seller at common law.

The "collateral sources" rule at common law would have yielded the same result. Benefits are deemed "collateral" under that rule depending on their character and purpose. See *Haughton* v. *Blackships, Inc.*, 462 F.2d 788, 790-791 (5th Cir. 1972). The tax benefits at issue here were conferred upon investors by Congress for the purpose of stimulating certain kinds of real estate activity deemed socially desirable. The fraudulent promoter, being the mere incidental beneficiary of Congress's largesse, has no legitimate claim to those tax savings. Any tax benefits accruing to the investor would thus constitute "benefits conferred on the injured party from other sources" (Restatement (Second) of Torts § 920A(2) (1979)). It is true that a tax-shelter promoter functions in a sense as the but-for cause of deductions that the investor claims, and it is likewise true that tax considerations loom large in the typical investor's mind. But those facts do not make the plaintiff's tax benefits any less "collateral" in their origin. A doctor who provides medical services may be the but-for cause of his patient's claim to reimbursement from an insurance company, as well as of his patient's claim to a tax deduction for the medical expenses not so reimbursed. See Internal Revenue Code of 1954 (I.R.C.) § 213(a). In an action seeking recovery for medical malpractice, however, both types of benefits, being "benefits conferred on the injured party from other sources," would be deemed by the common law to emanate from "collateral sources" and hence would not serve to reduce the defendant's liability for damages.

B. The Measure Of Damages Under Sections 12(2) And 10(b) Is At Least As Favorable To The Plaintiff As The Common-Law Remedies For Securities Fraud

Private remedies under the federal securities laws were designed to supplement and enhance, not to diminish, the remedies available at common law. See *Bateman Eichler*, slip op. 8-11. In adopting its tax-offset

rule, the court of appeals has afforded the perpetrators of securities fraud a defense unknown to the common law and thus has given the federal remedial provisions an unduly narrow construction. That restrictive reading has scant support in the statutory language, and it is contrary to this Court's mandate that the securities laws be construed liberally to effectuate their remedial and deterrent purposes. *Herman & MacLean* v. *Huddleston*, 459 U.S. 375, 386-387 (1983); *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963). Far from "eschew[ing] rigid common-law barriers in construing the securities laws" (*Bateman Eichler*, slip op. 10), the court of appeals has erected novel barriers to a plaintiff's recovery, obstacles that would severely compromise the statutory objective of deterring fraud.

1. Section 12(2) of the 1933 Act, 15 U.S.C. 77*l*(2), provides that an investor who has been induced to purchase a security by a misleading prospectus or misleading oral communication

> may sue either at law or in equity in any court of competent jurisdiction to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon tender of such security * * *.

Section 12(2) alternatively permits a defrauded investor to sue "for damages if he no longer owns the security." Although the statute does not prescribe the mode of computing damages in the latter situation, courts and commentators have uniformly viewed Section 12(2)'s restitutionary formula as governing the computation of all monetary awards thereunder.[8]

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[8] See *Wigand* v. *Flo-Tek, Inc.*, 609 F.2d 1028, 1034-1036 (2d Cir. 1979); 11 H. Sowards, *The Federal Securities Act and the Trust Indenture Act of 1939*, § 904[5], at 9-26 (1985); 6 L. Loss, *Securities Regulation* 1221 (Supp. 1969). Contrary to the court of appeals' statement (Pet. App. A12 & n.11), it is irrelevant under Section 12(2) whether a plaintiff seeks "actual rescission" or "rescissionary damages," since Section 12(2)'s restitutionary formula is the same in either event.

By enacting Section 12(2), Congress made available to defrauded investors a statutory version of the common-law remedies of rescission and restitution. In so doing, moreover, Congress substantially liberalized the common-law cause of action. Section 12(2) eliminated the common-law requirement that an investor prove reliance on the fraudulent representations. It relaxed the strict privity requirements of common law by permitting suit against persons other than the immediate seller. And it significantly eased the plaintiff's burden of proof by shifting to the defendant the burden of showing due care. See *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 209 n.27, 212-214 (1976); *Deckert* v. *Independence Shares Corp.*, 311 U.S. 282, 288 (1940); H.R. Rep. 85, 73d Cong., 1st Sess. 23-24 (1933); L. Loss, *Fundamentals of Securities Regulation* 1024-1025 (1983).

Congress did not specify, either in the text of the statute or in its legislative history, what constitutes "income received * * * on" a security for purposes of Section 12(2). Courts and commentators alike, however, have interpreted those words to mean payments (whether in cash or in valuable property) generated directly by the security itself, such as dividends or distributions on stock, interest on bonds or on other evidences of indebtedness, royalty payments on mineral interests, or production payments on oil and gas leases.[9] This construction of the words "income received thereon" is consistent with the doctrine of common-law restitution, under which a rescinding purchaser, in order to recover his consideration, was required to restore to the seller only the original property and its "direct product." See page 10, *supra*.

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[9] See, *e.g.*, *Wigand* v. *Flo-Tek, Inc.*, 609 F.2d at 1037 n.9; *Mott* v. *Tri-Continental Financial Corp.*, 330 F.2d 468, 470 (2d Cir. 1964); *Johns Hopkins Univ.* v. *Hutton*, 297 F. Supp. 1165, 1231-1233 (D. Md. 1968), aff'd in part and rev'd in part, 422 F.2d 1124 (4th Cir. 1970), cert. denied, 416 U.S. 916 (1974); *Wall* v. *Wagner*, 125 F. Supp. 854, 858 (D. Neb. 1954), aff'd, 226 F.2d 868 (8th Cir. 1955). See also Kaminsky, *An Analysis of Securities Litigation Under Section 12(2) and How It Compares with Rule 10b-5*, 13 Hous. L.Rev. 231, 281 (1976).

This construction is likewise faithful to the common-sense meaning of the words "income received."

In holding that tax benefits claimed by an investor constitute "income received * * * on" his limited partnership investment, the court of appeals has done considerable violence to the English language. A limited partnership investment, of course, may generate "income" of various kinds—rent, royalties, interest and capital gains are typical examples—and a limited partner's distributive share of those items would obviously constitute "income received * * * on" his investment for purposes of Section 12(2). The tax benefits made available by such an investment, however, are not "income received thereon." Rather, those tax benefits take the form of deductions and credits that an investor may use to *offset* the income that he receives *from other sources*, or to reduce the tax that he would otherwise owe on income independently generated. Indeed, the court of appeals itself acknowledged that tax benefits received are not "a form of income in a strict accounting sense" (Pet. App. A11 (footnote omitted)).[10]

The notion that tax benefits are "income received" likewise does violence to Congress's remedial purposes in enacting Section 12(2). As we have shown (pages 13-14, *supra*), a defrauded investor's tax savings would not have reduced a defendant's liability to pay damages at common law. When Congress codified the common-law remedy of rescission and restitution in Section 12(2), it took

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[10] This Court's statements in *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837 (1975), are relevant in this respect. The court of appeals there had held that shares in certain housing projects constituted an "investment contract," reasoning that such shares incorporated "an expectation of income" owing to "the deductibility for tax purposes of the portion of the monthly rental charge applied to interest on the mortgage" (421 U.S. at 852). Reversing the court of appeals, this Court wrote: "We know of no basis in law for the view that the payment of interest, with its consequent deductibility for tax purposes, constitutes income or profits" (*ibid.*). The Court added that, "[e]ven if * * * tax deductions were considered profits, they would not be the type associated with a security investment since they do not result from the managerial efforts of others" (*id.* at 855 n.20).

steps to *liberalize* that cause of action so as to remove common-law barriers to recovery. See page 16, *supra*. Given that expansive purpose, Congress can scarcely have intended that Section 12(2) should be interpreted to erect a barrier to recovery that the common law itself did not recognize.

2. The court of appeals' tax-offset rule is equally inappropriate in computing damages under Section 10(b) of the 1934 Act, which the district court held would "independently support[]" (Pet. App. E16) a grant of relief here. Section 10(b) proscribes the use of manipulative and deceptive practices "in connection with the purchase or sale of any security" (15 U.S.C. 78j(b)). Recoveries under Section 10(b) and Rule 10b-5 in turn are subject to Section 28(a) of the 1934 Act, which states (15 U.S.C. 78bb(a)):

> The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of.

Although the term "actual damages" is not defined in the securities laws, it had a well-established meaning when the Securities Exchange Act was enacted. The term "actual damages" was generally understood in 1934 to permit any appropriate recovery of nonspeculative, compensatory damages.[11] Section 28(a) has consistently been

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[11] In suits for patent infringement, for example, the statutory measure of damages had long been based on the "actual damages sustained" by the plaintiff. Act of July 4, 1836, ch. 357, § 14, 5 Stat. 123. Construing that term in *Birdsall* v. *Coolidge*, 93 U.S. 64, 70 (1876), this Court held that "[c]ompensatory damages and actual damages mean the same thing." Similarly, in interpreting a 1935 amendment to the Bankruptcy Act that used the term "actual damage" (Act of Aug. 27, 1935, ch. 774, § 77(b), 49 Stat. 914), this Court understood it to mean "compensatory damages," noting

interpreted in the same fashion. The statute has thus been held to permit recovery under traditional principles for determining compensatory damages, including the restitutionary measure familiar to the common law. See, *e.g.*, *Myzel* v. *Fields*, 386 F.2d 718, 740-742 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968); 5C A. Jacobs, *supra*, § 260.03[c]. In view of the limitation of a plaintiff's recovery to his "actual damages," Section 28(a) has been read to bar duplicative recoveries, as where a plaintiff asserts both federal and state claims arising out of the same course of conduct;[12] to preclude the award of punitive, as opposed to compensatory, damages;[13] and to preclude compensation for such non-economic losses as pain and suffering, emotional distress, and loss of image or prestige.[14]

In construing the statute to require reduction of a plaintiff's restitutionary award on account of his tax benefits, the court of appeals took an unduly narrow view of the concept of "actual damages" under Section 28(a). As this Court has recently emphasized, "[t]he Securities Act of 1933 and the [Securities Exchange] Act of 1934 'constitute interrelated components of the federal regulatory scheme governing transactions in securities.'" *Herman & MacLean* v. *Huddleston*, 459 U.S. at 380 (quoting *Ernst & Ernst* v. *Hochfelder*, 425 U.S. at 206). See *United States* v. *Naftalin*, 441 U.S. 768, 778 (1979). The remedial provisions of the two statutes should therefore be read in pari materia. See *Globus* v. *Law Research*

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that "[t]he ways compensatory damages may be proven are many." *Palmer* v. *Connecticut Ry. & Lighting Co.*, 311 U.S. 544, 560-561 (1941).

[12] See, *e.g.*, *Osofsky* v. *Zipf*, 645 F.2d 107, 111 (2d Cir. 1981); 3 L. Loss, *Securities Regulation* 1624 n.5 (2d ed. 1961).

[13] See, *e.g.*, *Osofsky* v. *Zipf*, 645 F.2d at 111; *Gould* v. *American-Hawaii S.S. Co.*, 535 F.2d 761, 781 (3d Cir. 1976).

[14] See *Osofsky* v. *Zipf*, 645 F.2d at 111; *Frigitemp Corp.* v. *Financial Dynamics Fund, Inc.*, 524 F.2d 275, 281 (2d Cir. 1975); *Weiss* v. *Hayden Stone, Inc.*, 340 F. Supp. 1074, 1075 (E.D.N.Y. 1972); L. Loss, *Fundamentals of Securities Regulation* 1140-1141 (1983).

Service, Inc., 418 F.2d 1276, 1286 (2d Cir. 1969), cert. denied, 397 U.S. 913 (1970); L. Loss, *Fundamentals of Securities Regulation* 1147 (1983). As we have shown above, a plaintiff who receives a restitutionary recovery under Section 12(2) of the 1933 Act may not have his award reduced by reference to his tax benefits, both because tax benefits do not constitute "income received" within the meaning of that Section and because tax benefits would not have affected his recovery at common law. Where a restitutionary recovery is appropriate under Section 28(a) for a violation of Section 10(b), therefore, the measure of damages should be at least as broad as that under the common law and under Section 12(2).

3. In holding that restitutionary recoveries under Sections 12(2) and 10(b) must be reduced by tax benefits, the court of appeals reasoned that a contrary result would "penalize defendants" by awarding the plaintiff an amount in excess of his "actual monetary loss" (Pet. App. A13). As we explain more fully below (pages 22-27), the court of appeals proceeded from an erroneous premise. The Internal Revenue Code incorporates detailed mechanisms for preventing undeserved windfalls to taxpayers in situations of this sort. The tax-offset rule is thus unnecessary.

Even if the court of appeals' premise were correct, however, its tax-offset rule would still be unjustifiable. The tax-offset rule confers a windfall on the wrongdoer by letting him keep the fruits of his fraud. In calculating damages under the securities laws, courts must take care to avoid unjustly enriching defendants. The remedy of rescission and restitution at common law permitted a plaintiff to recover an amount in excess of his actual economic loss where necessary to prevent the wrongdoer's unjust enrichment; as between the wrongdoer and his victim, any doubt concerning entitlement to the benefits of a rescinded transaction was resolved in favor of the latter. See pages 11-12, *supra*. This Court has recognized that a measure of damages that prevents defendants from retaining their ill-gotten gains is fully appropriate under

the federal securities laws. *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 155 (1972). Courts measuring damages in securities-fraud cases have regularly looked to the defendant's profit rather than to the plaintiff's loss where necessary to prevent unjust enrichment, correctly reasoning that "[i]t is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them." *Janigan* v. *Taylor*, 344 F.2d 781, 786 (1st Cir.), cert. denied, 382 U.S. 879 (1965). In short, "[t]he damages ceiling imposed by [Section] 28(a) in terms of 'actual damages on account of the act complained of' does not foreclose a windfall recovery based on the defendant's benefit rather than the plaintiff's loss." L. Loss, *Fundamentals of Securities Regulation* 1134 (1983).[15]

These equitable principles show the error of the court of appeals' tax-offset rule. If there should remain, at the end of the day, any permanent tax benefits stemming from the rescinded investment, those benefits will have come at the expense of the public fisc. If those benefits are used to reduce the plaintiff's securities-fraud recovery, the effect is to transfer this species of publicly-funded largesse, dollar-for-dollar, from the plaintiff to the defendant. Such a result would produce unjust enrichment because, as between the plaintiff and the defendant who defrauded him, the plaintiff is plainly more equitably situated to retain the benefits that Congress has provided. The investor is not only the victim rather than the wrongdoer, but he is the party upon whom Congress conferred the tax benefits in the first place. If there is to be a windfall, the deterrent purposes of private actions under the

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[15] Accord, *e.g.*, *Hackbart* v. *Holmes*, 675 F.2d 1114, 1122 (10th Cir. 1982) ("[p]reventing unjust enrichment is a well-recognized exception to the rule limiting damages to the out-of-pocket loss"); *Nelson* v. *Serwold*, 576 F.2d 1332, 1338 (9th Cir. 1978) ("recent trend looks to defendant's profits, rather than to plaintiff's losses, in measuring damages"). See also *Zeller* v. *Bogue Electric Manufacturing Corp.*, 476 F.2d 795, 802 (2d Cir.), cert. denied, 414 U.S. 908 (1973); 5C A. Jacobs, *supra*, § 260.03[a], at 11-18; Thompson, *supra*, 37 Vand. L.R. at 372, 378-79.

securities laws mandate that it come to rest where Congress originally put it—with the plaintiff and not with the defendant.[16]

C. The Tax Laws, Without The Aid Of The Court Of Appeals' Tax-Offset Rule, Will Operate To Ensure That A Rescinding Purchaser Receives No Undeserved Windfall

Besides interpreting erroneously the rules governing damages in securities cases, the court of appeals' decision is wrong as a matter of tax law. In appraising a defrauded plaintiff's overall tax benefits, it is necessary to consider, not only the tax benefits previously claimed, but also the tax consequences of the fraud recovery itself. Where, as here, the award will be subject to tax, it is obviously improper to base that award on an after-tax estimate of the plaintiff's loss. In *Hanover Shoe, Inc.* v. *United Shoe Machinery Corp.*, 392 U.S. 481 (1968), a case involving the computation of antitrust damages, this Court held that a plaintiff's award for lost profits must be based on what its pre-tax profits would have been absent the antitrust violation, given the fact that the antitrust award would itself be taxable in the plaintiff's hands. To reduce the plaintiff's damages by the taxes that would have been payable on the lost profits, the Court held, "would be to apply a double deduction for taxation" (392 U.S. at 503). Compare *L.P. Larson Co.* v. *Wm. Wrigley Co.*, 277 U.S. 97, 100 (1928) (award for lost profits based on pre-tax earnings where award is taxable), with *Norfolk & W. Ry. v. Liepelt*, 444 U.S. 490, 496 (1980) (award for lost income based on after-tax earn-

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[16] The conclusion that tax savings should not offset the defrauding seller's duty to refund the buyer's consideration under Section 12(2) also dictates that tax savings should not affect the seller's duty to pay "interest thereon" (15 U.S.C. 77*l*(2)). The court of appeals below thus erred (Pet. App. A19-A21) in computing petitioners' prejudgment interest. Although the Ninth Circuit has rejected the tax-offset rule in other respects (*e.g.*, *Burgess* v. *Premier Corp.*, 727 F.2d 826, 837-838 (1984)), it likewise has erred in holding that a plaintiff's tax savings may offset his prejudgment interest (*id.* at 838).

ings where award is not taxable), and *Jones & Laughlin Steel Corp.* v. *Pfeifer*, 462 U.S. 523, 534 (1983) (same).

The court of appeals recognized (Pet. App. A22) that the application of its tax-offset theory, without more, would have imposed a double burden on petitioners by reducing, with reference to past tax savings, a damages recovery that would itself be taxed. In apprehending that fact, the Eighth Circuit identified an egregious error committed by other courts that have considered this question.[17] Given the chance to avoid one error, however, the court of appeals proceeded to commit two. The court declined to follow this Court's reasoning in *Hanover Shoe*, under which a taxable award of damages should be based on the plaintiff's *pre-tax* loss. Instead, the court of appeals persisted in applying its tax-offset rule, basing its tentative award of damages on petitioners' *after-tax* loss, and then, in order to reflect the award's taxability (Pet. App. A22), arbitrarily doubled the amount previously computed.

As a matter of tax law, not to mention common sense, the court of appeals' approach is seriously flawed. Its approach is inherently arbitrary, since it is based (Pet. App. A22) on unsubstantiated assumptions about petitioners' tax brackets and about how their awards will be taxed. The court's two errors, while seemingly symmetrical conceptually, do not cancel each other out in practical effect, but rather yield awards that are small fractions of what they would have been if the tax consequences were ignored altogether. See pages 6-7 note 1, *supra*. Most fundamentally, the Internal Revenue Code incorporates sophisticated mechanisms for preventing undeserved windfalls to taxpayers in circumstances like those here. Those mechanisms, unaided by the court of appeals' tinkering, will achieve the result that the court of appeals desired, and will do so in the manner that Congress has ordained.

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[17] See *Salcer* v. *Envicon Equities Corp.*, 744 F.2d 935 (2d Cir. 1984), petition for cert. pending, No. 84-1447; *Freschi* v. *Grand Coal Venture*, 767 F.2d 1041 (2d Cir. 1985), petition for cert. pending, No. 85-377.

1. The anticipated "tax benefits" stemming from a real estate tax shelter principally include losses that pass through from the partnership to the partners and become available as deductions against otherwise-taxable income on the partner's individual return. Such losses also serve to reduce, dollar-for-dollar, the partner's cost, or tax "basis," of his investment. A real estate tax shelter typically employs leveraged financing, permitting investors to secure current deductions in excess of their cash outlay. These deductions are counterbalanced in the year the investment is sold by the requirement that the investor include in his "amount realized," for purposes of computing his taxable gain, the amount of debt from which he is thereby discharged. *Commissioner* v. *Tufts*, 461 U.S. 300 (1983); *Crane* v. *Commissioner*, 331 U.S. 1 (1947). Generally speaking, a partner's gain on disposition of his investment will be taxable at preferential capital gains rates. However, some of the tax benefits generated during a tax shelter's early years—such as accelerated depreciation and investment tax credits—are subject to "recapture" as ordinary income upon that disposition. See, *e.g.*, I.R.C. §§ 47, 48(q), 1245, 1250; *Commissioner* v. *Tufts*, 461 U.S. at 303 n.2. In sum, tax shelters generally provide a form of tax deferral and, in certain circumstances, conversion of ordinary income into capital gain, rather than a means of permanent tax avoidance. See Ginsburg, *The Leaky Tax Shelter*, 53 Taxes 719 (1978).

2. If an investor who has successfully claimed such tax-shelter benefits subsequently obtains a recovery in a securities-fraud suit, the effect of that recovery under the Internal Revenue Code will be to offset, in whole or in part, the tax benefits previously received. The precise manner in which this offset will be accomplished depends on several variables—whether the investor's tax returns have been audited by the IRS, what steps he has previously taken with respect to his investment, and what kind of recovery he obtains in the securities action. Under any scenario, however, the tax laws will require the partner

to settle his accounts with the IRS—once all the facts surrounding his unhappy investment are finally determined —so as to eliminate the possibility of his garnering any undeserved windfall.

If the defrauded partner wins relief in the nature of rescission, some if not all of his recovery will probably be taxed to him as ordinary income under the "tax benefit rule." As this Court recently observed, the tax benefit rule operates to "cancel out an earlier deduction" when a subsequent event is "fundamentally inconsistent with the premise on which the deduction was initially based." *Hillsboro Nat'l Bank* v. *Commissioner*, 460 U.S. 370, 383 (1983) (original quotation marks and footnote omitted). See, *e.g.*, *Unvert* v. *Commissioner*, 656 F.2d 483 (9th Cir. 1981), cert. denied, 456 U.S. 961 (1982) (requiring tax-shelter investor to recognize income on recovery of funds from promoter, where amounts had been deducted in previous tax year). Alternatively, if the defrauded partner wins out-of-pocket damages, the damage award generally will serve to reduce the basis of his partnership interest. If he has already disposed of his interest, or if he has reduced his basis to zero by previously-claimed deductions, the entire damage award will represent taxable income when received. Such an award might be taxed, in whole or in part, as ordinary income under the tax benefit rule or under the Code's various "recapture" provisions. The manner in which the recovery will be taxed may also depend on the taxpayer's earlier treatment of his investment for tax purposes, *e.g.*, on whether he had previously deducted it in full as a worthless security or as a theft loss. See I.R.C. § 165(c)(3), (e) and (g); *Boehm* v. *Commissioner*, 146 F.2d 553 (2d Cir.), aff'd, 326 U.S. 287 (1945). Any portion of the recovery not taxed as ordinary income would be taxed at capital gains rates. See *Raytheon Production Corp.* v. *Commissioner*, 144 F.2d 110 (1st Cir.), cert. denied, 323 U.S. 779 (1944).

As the court of appeals perceived, the mechanisms described above are unlikely in any case to eliminate the economic value of tax benefits previously enjoyed. A deduction in year one, coupled with the inclusion in income

of an identical amount in year ten, will rarely yield precisely offsetting economic consequences, owing to the time value of money, possible changes in tax rates, and intervening changes in the investor's tax bracket. See *Alice Phelan Sullivan Corp.* v. *United States*, 381 F.2d 399 (Ct. Cl. 1967). As this Court has explained, however, the purpose of the tax benefit rule is not to achieve mathematical perfection but "to achieve rough transactional parity in tax" (*Hillsboro Nat'l Bank*, 460 U.S. at 383). It would surely be more accurate, from a conceptual point of view, not to tax a restitutionary award upon receipt, but instead to reopen the taxpayer's earlier years and disallow all deductions and credits predicated on his ownership of the now-rescinded investment. As this Court noted in *Hanover Shoe*, however, "the statute of limitations frequently will bar the Commissioner from recomputing for earlier years," and such recomputations in any event would be "immensely difficult or impossible when a long period has intervened" (392 U.S. at 503). For these reasons, and because of the well-established "annual accounting principle," the IRS "in practice * * * has taxed recoveries for tortious deprivation of profits at the time the recoveries are made, not by reopening the earlier years." *Ibid.* (citing *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426 (1955)). While this result may lack conceptual purity in the eyes of some, and while it may often permit an injured plaintiff ultimately to recover an amount somewhat in excess of his actual economic loss, Congress has determined, and this Court has agreed, that "the rough result of not taking account of taxes for the year of injury, but then taxing [the] recovery when received, seems the most satisfactory outcome" (*Hanover Shoe*, 392 U.S. at 503). The court of appeals had no license to opt for a different calculus, even if equity supported that choice, which it does not.

3. The above discussion is not intended as an exhaustive catalog of tax consequences, which can be extremely complex and take years to resolve. The point is simply that the Internal Revenue Code, left to its own devices, will prevent the plaintiff from receiving any "undeserved

windfall" (*Salcer*, 744 F.2d at 942). If a defendant has defrauded a plaintiff, the damages should be measured by the plaintiff's loss *on his investment*. The tax ramifications of the award are a matter between the plaintiff and the IRS. Once the securities lawsuit is over, and the relevant facts are finally determined, those ramifications will be sorted out, on a case-by-case basis, under well-established tax principles. If, when the dust has settled, the plaintiff emerges with net tax benefits, and if that is considered a "windfall" to him, the windfall is not "undeserved." It is not undeserved because it reflects the customary operation of tax rules that Congress has designed specifically to deal with the situation at hand. And it is not undeserved because the plaintiff in any event is the victim rather than the perpetrator of fraud.

D. The Tax-Offset Rule Would Impede The Administration Of The Federal Securities And Tax Laws

In insisting upon the offset of previously-claimed tax benefits, the court of appeals has opted for an impractical and inequitable result that would have a significant adverse impact on administration of the federal securities and tax laws. Just last Term, this Court emphasized once again the important deterrent value of private actions, observing that they "provide a most effective weapon in the enforcement of the securities laws." *Bateman Eichler*, *supra*, slip op. 10 (original quotation marks omitted). By improperly reducing—and often, as was true in *Salcer*, eliminating entirely—the damages recoverable by plaintiffs who have been defrauded in tax-shelter schemes, the tax-offset rule would necessarily lessen the incentives for promoters to comply with the securities laws by permitting wrongdoers to retain the fruits of their fraud.

The tax-offset rule is particularly noxious because the perimeters of its application are so unclear. The court of appeals purported to restrict its applicability to "the special case of a tax shelter investment" (Pet. App. A8), but we see no principled basis for that limitation, even if it were possible to say which tax-preferred investments

are "shelters" and which are not. Although tax advantages are particularly prominent in the case of real estate partnerships like that involved here, tax considerations play a significant role in countless investment decisions, from the purchase of municipal bonds and of interests in oil wells to investment in IRA accounts and "all-savers certificates." People may be motivated to buy common stocks rather than bonds because of the annual dividend exclusion (I.R.C. § 116); they may be motivated to buy low-yielding growth stocks rather than high-yielding blue chips in the hope of having their profits taxed as long-term capital gain rather than ordinary dividend income; and they may be motivated to buy shares of public utilities in the hope of receiving return-of-capital distributions (I.R.C. § 301(c)(2)) or avoiding current taxation on "qualified reinvested dividends" (I.R.C. § 305(e)). While it had previously seemed settled that a plaintiff's tax savings are irrelevant in computing damages where such investments are concerned,[18] the court of appeals' analysis would make the outcome most unclear.

Besides being applicable to routine securities investments, the tax-offset rule is expandable to routine tax deductions. The Eighth Circuit below reduced petitioners' damages on account of tax benefits passed through to them by the limited partnership itself. In *Freschi* v. *Grand Coal Venture*, 767 F.2d 1041 (1985), petition for cert. pending, No. 85-377, however, the Second Circuit reduced a plaintiff's damages because he had previously deducted his worthless tax-shelter investment as a "theft loss." See I.R.C. § 165(e); 767 F.2d at 1051. In extending the tax-offset rule to deductions claimed by taxpayers for losses suffered on disposition of investment assets, the Second Circuit's approach would affect the computation

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[18] See, *e.g.*, *Wiesenberger* v. *W.E. Hutton & Co.*, 35 F.R.D. 556, 558 (S.D.N.Y. 1964) (action for rescission of participation in oil venture); *Cooper* v. *Hallgarten & Co.*, 34 F.R.D. 482, 486 (S.D.N.Y. 1964) (action for rescission of investment in oil and gas leasehold). Cf. *Smolowe* v. *Delendo Corp.*, 136 F.2d 231, 238 (2d Cir.), cert. denied, 320 U.S. 751 (1943) (liability for "short-swing" trading profits under 15 U.S.C. 78p(b)).

of damages in virtually all securities transactions. The injustice of that approach is manifest: the promoter of a fraudulent investment is permitted to pocket the proceeds of his fraud because of a tax loss that his very fraud has generated. It had once seemed clear that tax savings of this sort are irrelevant in computing damages. See, *e.g.*, *G & R Corp.* v. *American Security & Trust Co.*, 523 F.2d 1164, 1176 (D.C. Cir. 1975) (refusing to allow offset of tax savings stemming from bad-debt deduction). But the court of appeals' analysis, particularly in light of the Second Circuit's adaptation of it,[19] is of such uncertain dimensions as to place the outcome in doubt.

From a tax perspective, the decision below is equally troubling. It will often happen, at the commencement of a securities action, that the tax returns on which the plaintiff claimed his deductions will be under audit by the IRS. In such circumstances, obviously, the plaintiff's "tax benefits" will be wholly speculative, and any effort to offset the damage award thereby will lapse into a tailspin of circular reasoning.[20] Most significantly, the court

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[19] The Second Circuit's approach in *Freschi* is equally pernicious in applying the tax-offset rule in computing "out-of-pocket" damages, which are based on the difference between the price paid for the security and its actual value at that time. The tax-offset rule is plainly at odds with the out-of-pocket measure of damages, under which the plaintiff *keeps* the security and is entitled to retain benefits stemming directly or indirectly from its ownership. See 5C A. Jacobs, *supra*, §§ 260.02 & n.3, at 11-13, 260.03[c][ii], at 11-29.

[20] It is no answer to suggest, as did the panel opinion below, that "[e]vidence of the audit and expert opinions as to its likely result" should be introduced at trial, with "[t]he jury [being] entitled to determine whether and to what extent there would be a disallowance of deductions" (Pet. App. D27). The prospect of juries guessing about the outcome of complicated tax audits is altogether impractical. Nor is it any answer to demand, as did the Second Circuit in *Salcer*, that the IRS speed up its audit procedures "rather than attempt to place the issue in limbo indefinitely" (744 F.2d at 943). The difficulties attending audits of tax shelters, which may have thousands of investors nationwide, are formidable, and recently prompted Congress to enact detailed remedial legislation. See Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248,

of appeals' tax-offset rule "make[s] the government the banker for fraudulent tax shelter activity." *Burgess* v. *Premier Corp.*, 727 F.2d 826, 838 (9th Cir. 1984). There is no reason why a defendant's liability for his fraud should be diminished at the expense of his victims, or at the expense of the Nation's taxpayers generally.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

CHARLES FRIED
Solicitor General

ROGER M. OLSEN
Acting Assistant Attorney General

LAWRENCE G. WALLACE
Deputy Solicitor General

ALBERT G. LAUBER, JR.
Assistant to the Solicitor General

DANIEL L. GOELZER
General Counsel

ANN BELANGER DURNEY
TERESA E. MCLAUGHLIN
Attorneys

PAUL GONSON
Solicitor

JACOB H. STILLMAN
Associate General Counsel

RICHARD A. KIRBY
Assistant General Counsel

MARTHA H. MCNEELY
CATHERINE T. DIXON
Attorneys
Securities and Exchange Commission

JANUARY 1986

Tit. IV, § 402(a), 96 Stat. 648-669 (enacting I.R.C. §§ 6221-6232). We have been informed by the IRS that more than 30,000 tax shelter cases are currently pending in the Tax Court, representing almost 40% of that court's docket.

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No. 85-519

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1985

DR. WILLIAM C. RANDALL, DR. ROGER E. AUSTIN, DR. TOM W. ANDERSON and DR. MYREL A. NEUMANN,
Petitioners,

v.

B. J. LOFTSGAARDEN; ALOTEL INCORPORATED, a Minnesota corporation; PROPERTY DEVELOPMENT AND RESEARCH COMPANY, a Minnesota corporation; and 2361 BUILDING CORPORATION, a Minnesota corporation,
Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR ENVITEX REALTY CORP. AS AMICUS CURIAE IN OPPOSITION TO THE PETITIONERS

SPENGLER CARLSON GUBAR
BRODSKY & FRISCHLING
280 Park Avenue
New York, New York 10017
Attorneys for Envitex Realty Corp.

Of Counsel:

Edward Brodsky
Thomas H. Sear
Robert Knuts

19pp

QUESTION PRESENTED

Whether, in an action brought under the federal securities laws involving a tax shelter investment, the amount of damages recoverable by the tax shelter investor, if any, should be reduced by the amount of the permanent tax benefits that the tax shelter investor received as a direct result of his investment in the tax shelter?

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No. 85-519

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1985

DR. WILLIAM C. RANDALL, DR. ROGER E. AUSTIN, DR. TOM W. ANDERSON and DR. MYREL A. NEUMANN,
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v.

B. J. LOFTSGAARDEN; ALOTEL INCORPORATED, a Minnesota corporation; PROPERTY DEVELOPMENT AND RESEARCH COMPANY, a Minnesota corporation; and 2361 BUILDING CORPORATION, a Minnesota corporation,
Respondents.

BRIEF FOR ENVITEX REALTY CORP. AS AMICUS CURIAE IN OPPOSITION TO THE PETITIONERS

Preliminary Statement

This brief is filed by Envitex Realty Corp. ("Envitex") as amicus curiae in opposition to the petitioners. It is filed with the consent of the petitioners and the respondents.

Interest of Amicus Curiae

Envitex's interest in this case ("*Loftsgaarden*") arises out of its position as a defendant-respondent in *Salcer v. Envicon Equities Corp.* ("*Salcer*"), an action

now pending before this Court on a petition for a writ of certiorari. 744 F.2d 933 (2d Cir. 1984), *petition for cert. filed*, 53 U.S.L.W. 3688 (U.S. March 13, 1985) (No. 84-1447).

In *Salcer*, plaintiffs alleged that Envitex had violated the Securities Exchange Act of 1934 (the "Exchange Act") in connection with the sale of limited partnership interests in a real estate tax shelter partnership (the "Partnership"). As an affirmative defense, Envitex asserted that plaintiffs had received cash and tax benefits in an aggregate amount that exceeded their out-of-pocket investment in the Partnership and that those receipts would have to be deducted from any claims for damages.

The *Salcer* plaintiffs moved to strike this defense on the ground that it was inadequate as a matter of law. The district court agreed and granted the motion. The United States Court of Appeals for the Second Circuit, however, reversed. The Second Circuit held that the motion to strike was granted prematurely and rejected the arguments of the plaintiffs as well as those of the Securities and Exchange Commission and United States' Department of Justice who appeared as amici curiae. The Second Circuit held that it was not, as a matter of law, improper to deduct permanent tax benefits from an award of damages under the Exchange Act.

The *Salcer* plaintiffs then petitioned this Court for a writ of certiorari, which petition is still pending. Because this Court's decision in *Loftsgaarden* may apply to all federal securities fraud cases involving tax shelter investments, including *Salcer*, Envitex's interests may be directly affected by that decision. Therefore, Envitex respectfully submits this brief for the Court's consideration.

Summary of Argument

Both the Eighth Circuit Court of Appeals in *Loftsgaarden* and the Second Circuit Court of Appeals in *Salcer* correctly held that, when a plaintiff alleges securities fraud in connection with a tax shelter investment, any damage award must be reduced by the amount of the permanent tax benefits that plaintiff received as a direct result of his investment. This rule is required by both the statutory language of the Exchange Act and a common sense analysis of the economic environment of tax shelter investments.

To pretend that permanent tax savings are not equivalent to dollars physically transferred to the investor, as the petitioners would have this Court believe, is preposterous. An investor's primary purpose in investing in a tax shelter is, more often than not, to save taxes. Thus, if permanent tax savings were not deducted from a damage award, a plaintiff would be permitted to purchase a tax shelter for the purpose of saving taxes, receive permanent tax savings in excess of his investment and then institute a law suit against persons associated with the tax shelter even though he had not lost a single dollar from his investment and had, in fact, achieved the compensatory purpose of his investment. Such a result is entirely inconsistent with the purpose of allowing private civil actions to be brought under the Exchange Act. The Exchange Act does not provide a mechanism for defrauded purchasers or sellers of securities to receive monies well in excess of any actual damages suffered as a direct result of their investment.

In an effort to persuade this Court to ignore the economic reality of tax sheltered investments, petitioners, and the United States and the Securities and Exchange Commission (the "Government") as amici curiae in support of petitioners, present a variety of arguments which

distort the reach as well as the principles of law underlying the holdings in *Loftsgaarden* and *Salcer*. The petitioners and the Government urge this Court to overturn the well-reasoned *Loftsgaarden* and *Salcer* decisions on the ground that these decisions adversely impact the deterrent value of private civil actions brought under the federal securities laws and on the ground that due to these decisions, defendants will be unjustly enriched at the expense of the nation's taxpayers. All of their arguments, however, fail to overcome the fundamental fairness of deducting from a damage award the very type of compensation sought by a purchaser of a tax sheltered investment, that is, permanent tax savings received in strict compliance with the tax laws of the United States. Accordingly, the petitioners' and Government's arguments must be rejected and the decision of the Eighth Circuit affirmed.

ARGUMENT

UNDER THE EXCHANGE ACT, PERMANENT TAX BENEFITS RECEIVED BY A PLAINTIFF MUST BE DEDUCTED FROM THE GROSS DAMAGES CLAIMED BY THE PLAINTIFF

A. The Exchange Act and Common Sense Support Deduction of Permanent Tax Benefits Received By Investors

Section 28(a) of the Exchange Act limits the amount of damages recoverable for violations of the Exchange Act to "actual damages." "Actual damages" are equivalent to a plaintiff's "net economic loss." *Marbury Management Inc. v. Kohn*, 470 F. Supp. 509, 516 (S.D.N.Y. 1979), *modified on other grounds*, 629 F.2d 705 (2d Cir.), *cert. denied sub nom. Wood Walker & Co. v. Marbury Management, Inc.*, 449 U.S. 1101 (1980). In addition, when a plaintiff cannot show that he has suffered any actual pecuniary loss, his claim under section 10(b) will be dismissed. *See Fershtman v. Schectman*,

450 F.2d 1357, 1361 (2d Cir. 1971), *cert. denied*, 405 U.S. 1066 (1972); *Levine v. Seilon, Inc.*, 439 F.2d 328, 335 (2d Cir. 1971).

Furthermore, it is well established that the purpose of an award of damages in common law actions for fraud or deceit is to place the plaintiff in the position he would have been in if the injury had not occurred. *Harris v. Standard Accident and Insurance Co.*, 297 F.2d 627, 631-32 (2d Cir. 1961), *cert. denied*, 369 U.S. 843 (1962); *Glidden Company v. Hellenic Lines, Ltd.*, 207 F. Supp. 262 (S.D.N.Y. 1962), *aff'd*, 315 F.2d 162 (2d Cir. 1963); C. McCormick, *Damages* §§ 121, 449 (1935); Restatement (Second) of Torts §901 (1979). Accordingly, a failure to deduct all benefits received by a plaintiff would award the plaintiff a windfall and place him in a *better* position than he would have been had he not made the investment. Such an award would be the equivalent of an award of punitive damages which is prohibited by section 28(a) of the Exchange Act. *Osofsky v. Zipf*, 645 F.2d 107 (2d Cir. 1981); *Byrnes v. Faulkner, Dawkins & Sullivan*, 550 F.2d 1303, 1313 (2d Cir. 1977); *Green v. Wolf Corp.*, 406 F.2d 291, 293 (2d Cir. 1968), *cert. denied*, 395 U.S. 977 (1969).

Applying these principles to this case or to other actions brought by allegedly defrauded investors in tax shelters under the Exchange Act requires that all permanent tax benefits received by the defrauded investors as a result of their investment be deducted from their claim for damages. The amount an investor is willing to pay for an interest in a tax shelter is a function of the perceived economic benefits, that is, the tax savings[1] as

1. "In general, a tax shelter is an investment in which a significant portion of the investor's return is derived from the realization of tax savings with respect to other income, as well as the receipt of tax-favored (or, potentially tax-exempt) income from the investment itself." Staff, Joint Committee on Taxation, *Proposals Relating To Tax Shelters and Other Tax-Motivated Transactions* 4 (1984).

well as any capital appreciation he expects to derive from that investment. Thus, such tax savings are part of each investor's anticipated economic return and must be deducted.

> Return from a tax sheltered investment will consist of cash flow, tax benefits, and equity buildup and appreciation equity value. The elements of return are normally interdependent.
>
> . . . . [I]f tax benefits are increased, such increase will be at the expense of cash flow, the appreciation potential and equity buildup. If either cash flow or appreciation potential are enhanced, such enhancement may be at the expense of the other return component.
>
> Since all four items of return are relevant, *no method of analyzing the rate of return on the investment should fail to take into account all of the components*.

R. Haft & P. Fass, 4 *Tax Sheltered Investments* Intro.-11 to Intro.-12 (3d ed. 1985 revised) (emphasis added).

Because of an investor's expected tax savings, it is not unusual for an asset, such as the hotel development in the *Loftsgaarden* case, or the real estate development in the *Salcer* case, to yield a higher sales price when incorporated into a tax shelter offering than when sold in a simple purchase and sale transaction. Nor is it surprising that the tax benefits hoped to be obtained by a prospective investor in a tax shelter are very much a factor in the overall bargain. Thus, it follows that if damages are to be assessed based upon such an investor's purchase price, it is only appropriate to consider those potential benefits actually received by the investor which induced him to pay that purchase price.

In short, the fact that an investment yields different kinds of benefits should not mean, as the petitioners and

the Government argue, that only one kind of benefit should be considered in computing damages.[2] As the Eighth Circuit stated below,

> all economic benefits bargained for and received must be deducted from plaintiffs' damages because 'the strictly compensatory nature of damages awarded in private securities fraud actions requires that such value be taken into account in determining whether and to what extent damages were inflicted upon plaintiffs.' *Austin I*, 675 F.2d at 182.

Loftsgaarden, 768 F.2d 949, 955 (8th Cir. 1985). In recognition of the value of permanent tax savings, the Second Circuit in *Salcer* declared:

> It is not within our power to ignore benefits bargained for and received by plaintiffs as a result of the transaction at issue, which represent real economic value mitigating any loss they may have suffered.

Salcer, supra, 744 F.2d at 940.

Therefore, as both the *Loftsgaarden* and *Salcer* courts determined, consideration of the permanent tax savings received from a tax shelter investment complies with the provisions of the federal securities laws concerning private civil actions and recognizes the economic reality that these permanent tax savings represent real value bargained for by the tax shelter investor.

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2. Similarly, if an investor purchases an interest in a claimed "gold and silver" mine for $100 and no mine exists, the investor was damaged in the amount of $100. But if the investor receives a silver mine that contains no gold, one must compute the value of the silver to determine whether the investor has been damaged.

B. The Arguments of Petitioners and the Government Are Not Persuasive Because They Ignore the Fundamental Fairness of Deducting Tax Benefits

In an attempt to persuade this Court to ignore the economic reality of tax sheltered investments and the fundamental fairness of deducting permanent tax savings from any damage awards concerning investments designed to produce these tax savings, petitioners and the Government set forth a variety of arguments based upon principles of common law, tax law and public policy. For the reasons set forth below, none of these arguments provide a basis for ignoring the permanent tax benefits actually received by an investor when calculating damage awards under the Exchange Act.

1. "Collateral Source" Rule

Petitioners and the Government argue that tax benefits received by plaintiffs must be ignored in calculating damages because tax benefits fall within the "collateral source" rule. This common law rule prohibits consideration of those benefits which are separate and distinct from plaintiffs' transactions with defendants and arise solely from unrelated third parties. However, as the Securities and Exchange Commission ("SEC") itself properly recognized in setting disclosure requirements for realty tax shelter offerings, tax benefits arising from such an investment are not separate and distinct from the investment but are the very essence of the offering.

In 1974, the SEC adopted Guide 60 as part of its Guide For The Preparation of Registration Statements. This Guide required the issuer to describe in detail the tax benefits which would accrue upon the sale or foreclosure of partnership property and upon the dissolution or liquidation of the partnership. Then, in 1982 the SEC

issued Industry Guide No. 5,[3] which superseded Guide 60 and required even greater disclosure of tax consequences.[4] Indeed, in accordance with the widely accepted precept that tax benefits are an inextricable part of a tax shelter offering, it has been held that the failure to properly advise investors of the appropriate tax effects of an investment in a tax shelter offering may itself constitute fraud. *See Sharp v. Coopers & Lybrand*, 649 F.2d 175 (3rd Cir. 1981), *cert. denied*, 455 U.S. 938 (1982).

In light of the SEC's stringent disclosure requirements on issuers concerning the tax benefits relating to tax shelter offerings, it is somewhat puzzling for the SEC to now contend that a tax shelter investor's tax benefits are not the "direct product" of the investment or that the promoters play only a "partial and indirect role" in generating these permanent tax savings. (Government's Brief at pp. 13-14) The SEC's Guides mandating the disclosure to investors of all relevant tax consequences prove that the receipt of tax benefits is an inextricable part of a tax shelter offering and may not be said to fall within the ambit of the "collateral source" rule.

Moreover, whether or not there are tax benefits to be obtained in an investment of this sort ultimately depends on how the shelter is structured, operated and presented. Tax savings will result from the operation of a tax shelter only if such an operation is in compliance with the tax laws of the United States. Thus, tax shelter promoters, attorneys and accountants may be criminally liable under 18 U.S.C. § 1001 and 26 U.S.C. § 7206 if the actual

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3. SEC Release No. 33-6384 (March 16, 1982) (47 Fed. Reg. 11476).

4. These guidelines apply to all private offerings of real estate tax shelters. See Hooper Kanouff, Smith & Peryam, SEC Staff Interpretative Letter, available Oct. 11, 1982, in which the staff of the SEC assert that compliance with Regulation D requires the inclusion of tax opinions as specified in Industry Guide No. 5 in private offering memorandum in order to satisfy the disclosure requirements of Regulation D.

operations of a tax shelter do not comply with the tax laws which sanction their existence. It is extremely unlikely that in such criminal prosecutions, the Government will claim that the tax benefits generated by the investment were merely "collateral" and not the direct result of the defendants' acts. Therefore, it is inconsistent and unpersuasive for the Government and the petitioners to make such claims here.

2. Deterrence of Frand and Defendants' "Unjust Enrichment"

Petitioners and the Government argue that defendants will somehow unjustly "profit" at the expense of the Government if permanent tax savings are taken into account in awarding damages. They also urge that damages should not be mitigated by the tax benefits earned in order to encourage private Rule 10b-5 actions in the tax shelter area. Their arguments, however, are misleading and fail to comport with the realities of tax shelter investments and the underlying policies for allowing private actions under Rule 10b-5.

a. Consideration of Tax Benefits Delivered to Investors Does Not Undercut Rule 10b-5 As a Fraud Deterrent or Allow Fraud to Go Unpunished

The express purpose of the private civil remedies provisions of the federal securities laws is to compensate plaintiffs, not to penalize defendants. *Salcer*, *supra*, 744 F.2d at 941. Even though Congress could have chosen to penalize defendants in drafting provisions for private actions under the securities laws, it elected instead to permit defrauded investors to sue for the difference between what the investment initially cost and what it ultimately yielded, that is, for "actual" damages or rescission. Securities Exchange Act of 1933, §§ 11, 12, 15 U.S.C. §§ 77k, 77l; Securities Exchange Act of 1934, § 28, 15

U.S.C. §77bb. Thus, Congress, while allowing compensation for fraud, limits private federal securities fraud litigation to those claims in which actual economic losses have been suffered.

Obviously, penalizing fraud is a proper function of federal and state agencies. The methods that have been used by federal and state agencies to penalize tax shelter securities fraud have included: SEC injunctive and disgorgement actions; IRS injunctive actions; administrative proceedings by the SEC or IRS to prevent persons who have committed fraud from practicing before its agency; injunctive actions and actions for civil fines by state attorneys general; and criminal prosecutions, both state and federal, under a variety of state and federal statutes. Rule 10b-5, however, was not intended to provide one of the means for bringing a private civil action for fraud *per se*.[5]

Moreover, affirming the decision of the Eighth Circuit would not necessarily mean that permissible Rule 10b-5 claims by tax shelter investors would be significantly curtailed. Petitioners' argument that the *Loftsgaarden* decision will "discourage" investors from filing federal securities fraud actions because William

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5. Examples of fraud which are not actionable under Rule 10b-5 include: fraud which induces a plaintiff to hold, rather than to sell, a security, *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975); fraud which the particular plaintiff knew about, did not rely on or should have discovered, *Bartels v. Algonquin Properties, Ltd.*, 471 F. Supp. 1132 (D. Vt. 1979); *Meier v. Texas Int'l Drilling Funds, Inc.*, 441 F. Supp. 1056 (N.D. Ca. 1977); fraud which did not cause damages to the plaintiff, *Levine v. Seilon, supra*; fraudulent events occurring after the fact of a sale of a security to the plaintiff, *Morgan v. Prudential Funds, Inc.*, 446 F. Supp. 628 (S.D.N.Y. 1978); fraud committed by an "insider" of a tenderor who fails to disclose an imminent tender to sellers of a target company's stock, even though such fraud is punishable by criminal fine and imprisonment, *Moss v. Morgan Stanley, Inc.*, 719 F.2d 5 (2d Cir. 1983), *cert. denied sub nom. Moss v. Newman*, 465 U.S. 1025 (1984).

Randall only recovered $506 completely ignores the compensatory purpose of private civil actions under these laws. (Petitioners' Brief at p. 35)

The facts in the case at bar and in *Salcer* are unusual because in both cases the permanent tax savings realized by the plaintiffs plus the cash recouped by the plaintiffs from their investment exceeded or nearly equaled the amount each plaintiff initially paid for his investment. This Court *should* discourage investors from filing federal securities fraud actions before they consult their accountants and determine whether or not they actually suffered any damages as a result of their investment. For the investor who has actually suffered damages, the *Loftsgaarden* decision will have no impact whatsoever on the investor's incentive or ability to institute a private civil action to recover those damages.

b. Defendants Do Not "Profit" From The Consideration of Tax Benefits In Computing Damages

Petitioners and the Government have erroneously argued that defendants will somehow "profit" unjustly if plaintiffs' tax savings are used to mitigate their damages. If this argument has any superficial appeal, it is only because the specter of "fraud" invokes the specter of undeserved "profit." Upon analysis, this argument has no substance.

The mere fact that defendants may pay less in damages simply means that plaintiffs did not actually suffer the full amount of damages claimed in their complaint, not that defendants are somehow unjustly enriched. Similarly, the Government's contention that defendants' liability is diminished "at the expense of the Nation's taxpayers" if tax savings are used to mitigate damages is absurd. None of the claims in this case or the *Salcer* case suggest that there was any fraud in connection with the tax shelter aspects of plaintiffs' investment activity. As noted by the Eighth Circuit below, the real estate projects involved in this case and *Salcer* strictly complied

with the provisions of the tax laws which provide tax benefits to persons who invested in these projects. *Loftsgaarden, supra*, 768 F.2d at 956. The "expense" to the Nation's taxpayers is exactly what the Government determined it should be in order to encourage the real estate development which actually occurred.

Properly stated, the issue here is "How much should plaintiffs recover?" Arguments premised on defendants' "profit" or "the expense to the Nation's taxpayers" are red herrings which seek to obscure the undeniable reality that plaintiffs have suffered only the minimal damages awarded by the Eighth Circuit in *Loftsgaarden*.

CONCLUSION

For all the reasons set forth above and for the reasons set forth in the brief submitted by respondents, this Court should affirm the decision of the Eighth Circuit.

Respectfully submitted,

SPENGLER CARLSON GUBAR
BRODSKY & FRISCHLING
Attorneys for Envitex Realty Corp.
280 Park Avenue
New York, New York 10017

Of Counsel:

Edward Brodsky
Thomas H. Sear
Robert Knuts